

Part 2
INVESTMENT COMPANY ACT AMENDMENTS OF 1967

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HEARINGS
BEFORE THE
SUBCOMMITTEE ON COMMERCE AND FINANCE
OF THE
COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE
HOUSE OF REPRESENTATIVES
NINETIETH CONGRESS

FIRST SESSION

ON

H.R. 9510, H.R. 9511

BILLS TO AMEND THE INVESTMENT COMPANY ACT OF 1940,
AS AMENDED, AND THE INVESTMENT ADVISERS ACT OF
1940, AS AMENDED, TO DEFINE THE EQUITABLE STAND-
ARDS GOVERNING RELATIONSHIPS BETWEEN INVEST-
MENT COMPANIES AND THEIR INVESTMENT ADVISERS
AND PRINCIPAL UNDERWRITERS, AND FOR OTHER
PURPOSES

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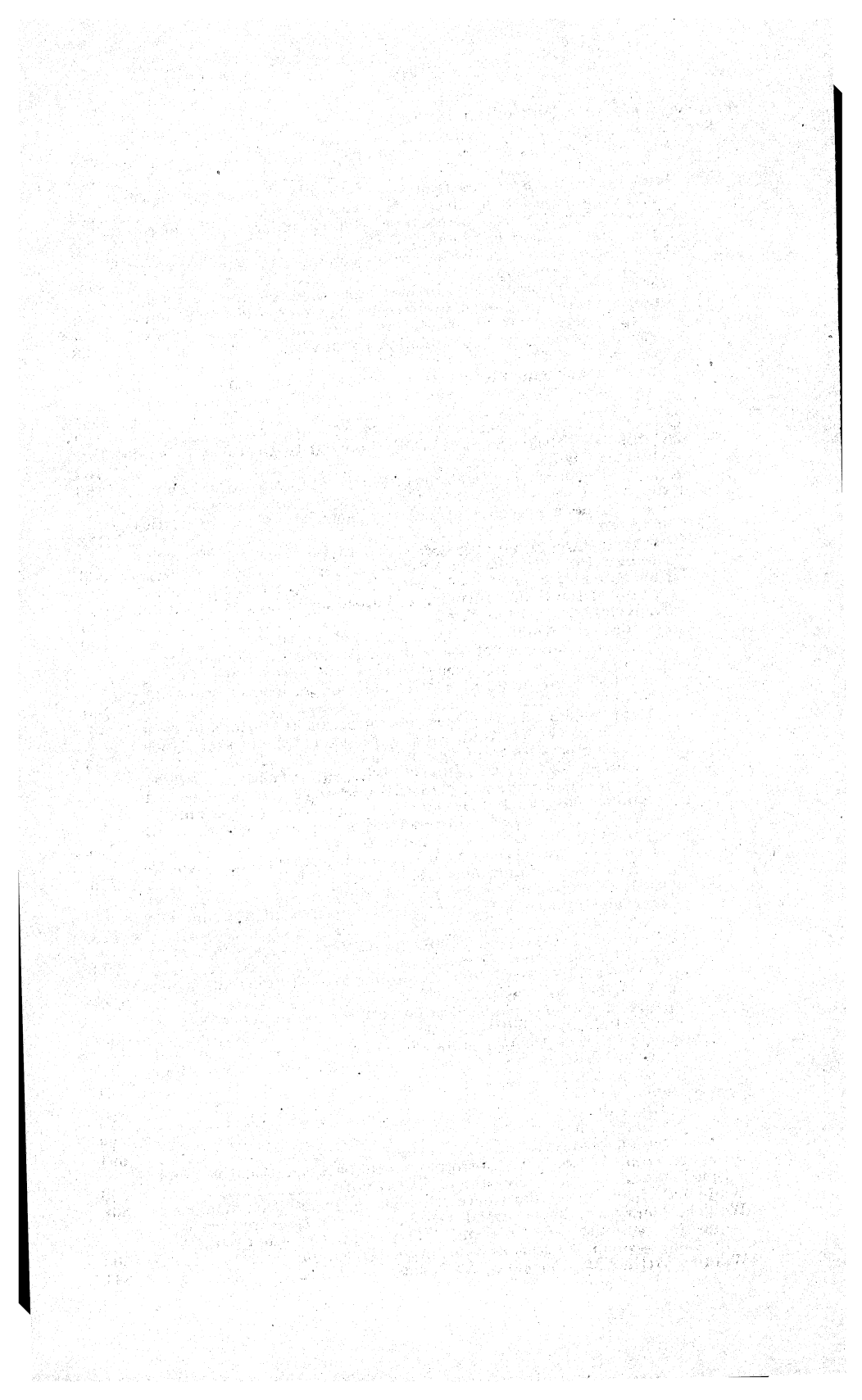
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INVESTMENT COMPANY ACT AMENDMENTS OF 1967

MONDAY, OCTOBER 16, 1967

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 2322, Rayburn House Office Building, Hon. John E. Moss (chairman of the subcommittee) presiding.

Mr. Moss. The committee will be in order.

We are resuming our hearings this morning on H.R. 9511. We have as our first witnesses the Association of Mutual Fund Plan Sponsors, Inc.: Mr. John H. Kostmayer, the coordinator; Mr. J. Edward Day; Mr. Cornelius Roach, chairman; and Mr. Rowland A. Robbins, president. Will you gentlemen take your seats. You may proceed, Mr. Roach.

I wonder if you would introduce, so that each member of the committee—

STATEMENTS OF CORNELIUS ROACH, CHAIRMAN OF THE BOARD, ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC.; ROWLAND A. ROBBINS, PRESIDENT; JOHN H. KOSTMAYER, COORDINATOR OF LEGISLATIVE EFFORTS; AND J. EDWARD DAY, COUNSEL

Mr. ROACH. Mr. Chairman and members of the subcommittee, on my right is Mr. Robbins, who is the president of the Association of Mutual Fund Plan Sponsors. Immediately to my left is Mr. John Kostmayer, who has been coordinator of the legislative efforts on behalf of the association. He is also vice president of First Investors Corporation, a sponsor of contractual plans, and Mr. Edward Day, former Postmaster General, who is appearing here as an expert witness in behalf of the association.

I am Cornelius Roach. I am vice president and general counsel of Waddell & Reed, Inc., national distributors of the United Funds group of mutual funds and sponsors of contractual plans for the accumulation of shares of certain of those funds. I have been continuously engaged in the mutual fund business for 16 years. I am also chairman of the board of the Association of Mutual Fund Plan Sponsors, Inc. I have already introduced those who are with me today.

The Association of Mutual Fund Plan Sponsors is an organization whose members conduct approximately 70 percent of the business in contractual plans. At the end of 1966, there were 48 sponsors offering the shares of some 65 mutual funds through contractual plans. It is

estimated that over 25 percent of the nearly 4 million persons owning mutual funds at the end of 1966 owned contractual plans. These plans called for aggregate payments of \$8,556,500,000, of which \$4,022,500,000 had been paid. Our statistics indicate that since passage of the Investment Company Act in 1940, something in excess of 2 million contractual plans have been sold in this country and that 82 percent of those plans made profits for their investors while simultaneously accomplishing their primary objective as well; namely, putting aside savings amounting to billions of dollars which those investors would otherwise have spent as disposable income.

It is this business that the SEC has asked the Congress to destroy. I use that term advisedly; it is not merely an exaggeration of a complaint about some minor increase in restrictions. Furthermore, the SEC has asked that you do this without showing the existence of any serious complaints or dissatisfaction on the part of the investing public.

As you have been informed, the contractual plan is an arrangement for investment in the shares of a mutual fund by the periodic payment of small sums of money over a term of years. In accordance with the provisions of the Investment Company Act of 1940, up to 50 percent of the first 12 payments may be deducted for sales charges. This is the so-called front-end load. The balance of the sales charges is spread over the remainder of the term. In the aggregate, sales charges upon completion of a plan are not higher than the usual sales charges on the shares of the underlying fund. The SEC asks that you prohibit the future sale of plans with a front-end load by repealing the section of the Investment Company Act—section 27(a)(2)—upon which the contractual plan is based. That means a complete prohibition of the sale of contractual plans and the consequent destruction of our business.

You can understand, therefore, why we consider it most important that this committee be fully informed about our business and about this proposal and about its effect upon us and the securities business generally; and we are most grateful for this opportunity to furnish this information and to present our view.

We appreciate that your time is limited and we intend not unduly to tax your patience. We have nine prepared statements with exhibits, on various facets of the proposal before you, which I should now like to submit for the record of these proceedings.

Mr. Moss. Without objection the statements will be received for the committee files at the present time until they have been fully reviewed. (The statement and exhibits referred to may be found in the committee files.)

Mr. ROACH. Thank you, sir. In addition, Mr. Kostmayer and Mr. Day will deliver oral statements. You will find copies of these oral statements on top of the envelopes which have been supplied. With your permission, Mr. Chairman, I should now like to call upon Mr. Kostmayer.

STATEMENT OF JOHN H. KOSTMAYER

Mr. KOSTMAYER. Mr. Chairman and members of the subcommittee, my name is John H. Kostmayer. I am a vice president of First Investors Corp., a member of the Association of Mutual Fund Plan Sponsors, Inc., and one of the largest and oldest firms in the contractual

plan business, and a member of the Association of Mutual Plan Fund Sponsors. During the past year I have also acted as coordinator of the efforts of the association in connection with the legislation which was proposed by the Securities and Exchange Commission.

I come before you today to tell you why we believe that the SEC recommendation to abolish the front-end load, and with it the contractual plan, should be rejected.

The contractual plan, which evolved in the early 1930's, represents a method of offering mutual fund shares to investors of moderate means who are interested in investing relatively small sums of money on a regular basis. To meet the heavy costs of offering and administering these plans out of the relatively small sums of money invested periodically and to compensate the salesman for the very considerable amount of time he spends in explaining and selling the plan, sponsors of contractual plans borrowed the sales charge structure generally applied to investment type life insurance; namely, the front-end load. It should be noted that even with the front-end load, most plan sponsors still lose money on a plan during its first year. The expense of front-end costs was recognized back in 1940 by the Congress that adopted the Investment Company Act. The report of the Senate Committee on Banking and Currency with respect to that act stated that the provision for the 50-percent-front-end load was made in recognition of the heavier initial expense incurred by sponsors in the sale of contractual plans.

Contractual plans are a very attractive investment program for a number of reasons. They provide a definite investment goal of a fixed amount; for example, \$2,000, \$3,000, or \$5,000. They can be started for as little as \$20 and continued with payments of as little as \$10 each month, while purchases of mutual fund shares pursuant to so-called voluntary or level load plans usually require much larger payments. The contractual plan investor can reinvest his capital gains dividends and ordinary income dividends without additional sales charges, while many so-called voluntary plans only permit capital gains dividends to be reinvested without sales charges, but impose a sales charge on reinvestment of ordinary income dividends.

Contractual plans provide flexibility in that payments may be made on schedule, accelerated, or postponed, all without penalty.

Mr. KEITH. Excuse me, Mr. Chairman.

Mr. MOSS. Mr. Keith.

Mr. KEITH. Is it invariably true that the contractual plan investor can reinvest his capital gains without additional sales charge?

Mr. KOSTMAYER. Invariably, Mr. Keith.

Mr. KEITH. Is it a matter of law?

Mr. KOSTMAYER. I would like to ask Mr. Roach.

Mr. ROACH. It is a matter of mechanics, sir. In the periodic investment plan it is a very formal plan, and it simply in its very nature includes the right and does include the right to invest both capital gains dividends and distributions. There is no provision for a payout in the nature of the plan, you see. There is nothing to be paid to the investor. It is all to be reinvested. That is the nature of the plan.

Mr. KEITH. But is it not within the realm of possibility, as is the case with many of the voluntary plans, there could be a varying policy.

Dreyfus, we found on examination the other day, does not charge for the reinvestment of dividends and capital gains, whereas Eaton & Howard funds do.

Now if you were required to lower your commissions on the front-end load, could you not seek additional income by charging for the reinvestment of the capital gains or the dividend income?

Mr. KOSTMAYER. Mr. Keith, our counsel informs us that he is under the impression that the SEC has ruled that it would be inconsistent with the 1940 act not to reinvest the income dividends without charge.

Mr. KEITH. So it is a matter of rule.

Mr. KOSTMAYER. Apparently.

Mr. KEITH. Rather than a matter of law.

Mr. KOSTMAYER. Apparently.

Mr. KEITH. And the SEC has not suggested changing that rule if they do away with the front-end load or reduce the front-end load, but it would seem that that is an opportunity for obtaining additional compensation from the contractual plan buyer out of dividend and capital gains reinvestments in later years.

Mr. KOSTMAYER. Mr. Keith, I think that the SEC's position has been, and very strongly held position, that it is completely and totally opposed to taking any sales charges out of reinvested income.

Mr. KEITH. They may have that position with reference to the contractual plans, but they do not have that position with reference to the other plans.

Mr. KOSTMAYER. They don't stipulate, but I think they advocate.

Mr. KEITH. If they do, they are not enforcing it.

Mr. KOSTMAYER. I don't think they have any legal right to enforce it, but I think this would be their choice. I think this is their expressed preference. There has been an attack on reinvesting dividends with a sales charge, by the SEC, on shares in voluntray plans.

Mr. KEITH. It was revealed here last Friday that there was a split on this in the voluntary plans—were you here last Friday?

Mr. KOSTMAYER. Right.

Mr. KEITH. Do you not recall the discussion?

Mr. KOSTMAYER. I had left before this discussion took place last Friday.

Mr. KEITH. We had some discussion about this, and Eaton & Howard's representative said that they levied a sales charge on reinvestment and gave it to the agent or the salesman that initially handled the account, if he was still in the business, or if not they gave it to other salesmen, and the thing that prompted it in my mind at that time was I had in the morning ridden down with a man who was delighted with his plan, but he resented the fact that he had to name a broker for the investment of this dividend income, and he felt that when he purchased the plan, he was going to get the additional investment without any sales charge. I am sure that he was not so advised, but that was his recollection some years later.

It just is an interesting thing that the typical fund plan other than contractual, I believe levy a sales charge, but you have once again the competition. Dreyfus with a half of one percent investment company fee does not charge for the reinvestment of dividends, whereas others with a lower fee do charge.

Mr. KOSTMAYER. Our thesis, Mr. Keith, that I want to develop here, is that our problem is with the front-end load and the necessity to compensate the salesman at the beginning, which compensation based on reinvestment of dividends would not in fact accomplish, but this is certainly something that we can look into.

Mr. KEITH. But if you are trying to build a career sales force, which you might have to resort to if the SEC has its way, and if you could, perhaps as life insurance companies do, hire people on a salary to start them out and keep them in the field, and recapture it from the charges against the reinvestment of dividend income or capital gains; you might have some plus factor there.

Mr. KOSTMAYER. It certainly would be some plus factor.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. MOSS. You may proceed.

Mr. KOSTMAYER. Thank you. All without penalty, and do not lapse in the sense that a life insurance contract may lapse. The underlying shares are redeemable at full value on any market day. In addition, the planholder has the valuable right to withdraw up to 90 percent of the then current liquidation value of the mutual fund shares held under his plan, and later to reinvest an equivalent amount without paying any sales charge at all.

Finally, and, most significantly, in my experience, the front-end load by itself is a very positive feature of the contractual plan. The sales charge and cost structure and the fact that early liquidation of a plan will probably result in a loss is explained by the salesman to the investor and is clearly and prominently disclosed in the prospectus which all prospective planholders receive, and they are required by sponsors to acknowledge this receipt in writing. The penalty feature of the front-end load encourages the investor to continue his payments and to save and invest systematically.

In my opinion the elimination or substantial modification of the load might well discourage investment persistency, thus destroying the contractual's utility to the investor. The tremendous popularity of the contractual plan is evidenced by the fact that over 25 percent of the nearly 4 million mutual fund shareholders at the end of 1966 were holders of contractual plans. This is no surprise, in view of the unique benefits the contractual plan offers and the highly profitable results which have been achieved for the large majority of investors.

These results are set forth in detail in the statement of Mr. Rowland A. Robbins which Mr. Roach has filed with you. Permit me to refer you to a pamphlet entitled "The Origin and History of the Contractual Plan," published by our association and prepared under the direction of our former chairman and counsel, the late James M. Landis, who had been Chairman of the Securities and Exchange Commission and dean of the Harvard Law School, and the 1966 supplement to that pamphlet, both of which were also filed with you by Mr. Roach. I now also offer for your files the 1967 supplement to that pamphlet, which has just been prepared and which contains more recent and comprehensive data.

(The supplement referred to may be found in the committee files.)

The several statistical studies in the 1967 supplement demonstrate beyond question that by far the largest percentage of investors in contractual plans have realized very substantial profits from their in-

vestments—even though they did not all complete their payments or complete them on time. On the other hand, only a very small percentage have liquidated their plans with losses, and those losses are infinitesimal in relation to the profits realized by those who have really taken advantage of the investment vehicle which has been made available to them.

Perhaps the most significant indication of this fact appears in the chart on page 9 of the 1967 supplement, which shows the history of every plan started by four different sponsors in 1951 or 1953. The study shows that, at December 31, 1966, of the almost 17,000 accounts involved, over 82 percent were either still open or had been liquidated with a gain, and that the profit realized by this 82 percent, who had invested \$39.8 million, amounted to almost \$33 million. The less than 18 percent of the accounts which had liquidated at a loss incurred aggregate losses of \$240,000. The losses of all planholders were, therefore, less than 1 percent of the payments made, while the profits, realized and unrealized, were over 80 percent of the payments made.

Despite these impressive end results, which should be the criteria by which to measure the merits of an investment vehicle, the SEC persists in its position that the contractual plan be abolished. It has attempted to minimize the significance of the profit results by pointing to the fact that a study as of the end of 1963 of the same 17,000 accounts which I just referred to showed that from 25 percent to over 40 percent of the planholders of the four plan sponsors had not progressed in their payments beyond those called for through the third year of their plans. This is true, but the SEC does not report the fact that of this group who, as of the end of 1963, had not progressed beyond the payments called for through the first 3 years of their plans, almost 55 percent had realized or unrealized gains of over \$1 million, and the remainder of 45 percent who terminated with losses had losses of \$160,000. Incidentally, several companies have initiated followup procedures to reactivate accounts that have stopped making payments. In my own company the reactivation figure has reached approximately 70 percent. Further experience should reduce this problem to nominal proportions.

The SEC asks that you prohibit the front-end load. This would mean denying to a significant segment of the investing public the unique benefits afforded by the contractual plan. The people who make up this market segment are investors of moderate means who would not have the opportunity to invest in equity securities unless the benefits of such investments were described to them by salesmen and who would not otherwise invest on a monthly or other periodic basis the relatively small sums of money that they have available for investment.

The SEC suggests that this is not so, because so-called voluntary or level load plans offer everything that contractual plans do and they are preferable because they do not involve the payment by the investor of a front-end load. Nothing could be further from the facts. Anybody familiar with our business will attest to the fact that most voluntary plans, unlike contractual plans, are not true accumulation plans.

The reason is simple. A salesman, because of the very small commissions he would receive on the sale of most voluntary plans, will not seek out this type of investor. For example, on the sale of a \$25-per-month voluntary plan, a salesman receives a little over \$1 as his share

of the commissions on the first, and every other, \$25 payment made. This just isn't enough incentive to encourage a salesman to seek out these investors. Most voluntary plans are opened when a salesman seeks out a customer who can make a substantial purchase of shares. If the salesman succeeds in making a substantial sale of shares, he may also offer the voluntary plan for share accumulation accounts as an additional service—as a convenient open account, or even as a plan program for future accumulation. Sometimes, he is disappointed in an effort to make a substantial cash sale and will end up by selling only a voluntary plan.

The contractual plan salesman, on the other hand, is willing to devote his time and effort to explaining his offering and its advantages to a responsible citizen who has a reasonably established income, and who may be convinced that it is to his advantage to use some of it to accumulate future capital. The fact that the contractual plan salesman devotes his time and effort to this end is demonstrated by the SEC report itself, which states that the average sale of a contractual plan requires three visits and the expenditure of a total of 3 to 4 hours by the salesman. Clearly, the investor who requires 3 to 4 hours of educational effort is not the one who walks into a brokerage house office and says that it occurs to him that he needs a monthly investment plan with diversification and professional management, and one that offers him a hedge against inflation.

Where the contractual plan is not available, however, most of these people are never approached by a salesman and never have the opportunity to accumulate capital through periodic investment in American business.

Nor does the voluntary plan offer the same stimulus to systematic investing which is created by the front-end load feature of the contractual plan. This point was raised by representatives of the Association of Mutual Fund Plan Sponsors with the SEC staff in August of 1963 when the "Report of the Special Study of Securities Markets" was released. Association representatives then suggested that the SEC staff make a study of voluntary plans to see whether they could establish the extent of persistency of payments in voluntary plans as contrasted with contractals. This is something that was not done.

This is something they did not do, but we have assembled sufficient figures to establish beyond question that contractual plans are much more effective in encouraging people systematically to save and invest than are voluntary plans.

For example, in the case of one mutual fund in a 3-year period studied, there were an average of 7.9 payments per year per account on contractual plans, as against an average of eight-tenths of one payment per account on the voluntaries; that is in the same fund. And in the case of another mutual fund in the same 3-year period, the discrepancy was still greater—an average of eight payments on contractals, as against an average of seven-tenths of one payment on voluntaries. There are additional studies to a similar effect with which I will not burden you in my oral presentation.

If I might digress for just a moment again, the message is clear, I think. Modification of the front-end load will reduce the stimulus to regular investing at great harm to investors.

In the SEC report, at the hearings before the Senate Committee on Banking and Currency, and again before this committee, the SEC has reiterated a cliché which it has propounded before—namely, that contractual plans are an unimportant vehicle for the purchase of mutual funds because in California, which does not permit the sale of contractual plans, more mutual fund shares are sold per capita than in any other State. The latter fact is undoubtedly true; however, the conclusion which the SEC seeks to draw from it is not.

The contractual plan is worthwhile because it is the only effective way by which mutual fund shares can be offered to investors of modest means who have not yet accumulated equity capital to date. In the absence of this plan, such persons are simply not given the opportunity to invest in equities, and that must be true of many thousands of Californians.

The citizens of California are avid purchasers of mutual funds. The reasons are understandable. We know, for instance, that the population in California includes a much larger percentage of persons who are either retired or otherwise have accumulated substantial amounts of capital which they are prepared to invest and need not rely upon current income for their investment capital. The manager of the California region of Mr. Roach's company, Waddell & Reed, Inc., a large mutual fund organization which also acts as a sponsor of contractual plans, estimates that approximately 75 percent of the mutual fund shares sold under his jurisdiction in that State are sold to retired people. Then, too, we know that the mutual fund idea in general has been much more widely accepted for a longer period by California securities dealers and salesmen than by those in almost any other State of the country—notably in some parts of the East where many large investment houses delayed, and in some cases still delay for years in perceiving the advantages of mutual fund investment for their customers. In addition, there is one mutual fund, Insurance Securities, Inc., in California which accounts for a substantial volume of mutual fund sales in that State, but in a very special form of sales medium. Finally, I understand from reliable sources that because of the closing of the Eastern securities markets in California—this would be at 12:30 because of the fact that the New York Stock Exchange closes at 3:30—salesmen have a much larger part of their active day to devote to the mutual fund shares than in most other time zones.

As a final comment on the SEC California argument, I would like to give you some statistics which the SEC fails to provide in conjunction with the California statistics. During 1966, sales of mutual funds on a per capita basis in Illinois, Wisconsin, and Ohio—the only other States in which contractual plans could not be sold—were significantly below the national average of \$23.08 per capita. In Illinois, they were \$18.23; in Wisconsin, \$16.59; and in Ohio, which incidentally now permits the sale of contractual plans, only \$15.17. These figures, I think, show that no conclusions at all with respect to contractual plans can be drawn from the California experience, except that their prohibition was not the cause of the results which the SEC describes.

Another basis upon which the SEC seeks to persuade the Congress to abolish the front-end load is that contractual plans are sold to uneducated or disadvantaged segments of the population who are par-

ticularly vulnerable to alleged "high pressure" selling. The facts show, however, that this is not the case at all. A nationwide survey was conducted by Benson & Benson, Inc., of Princeton, N.J., for Investment Company Institute which provides a profile of the contractual plan investor. The survey showed that the median contractual planholder is 43 years old; is a high school graduate or better; is engaged in a profession, or as an executive, or in a skilled or semiskilled capacity; owns a home worth \$17,000; carries \$13,000 of life insurance; holds cash and savings bonds and securities aggregating \$4,500; and has a family income of \$11,000 per year.

The survey shows conclusively that the contractual planholder has two outstanding characteristics which distinguish him from other mutual fund shareholders. One of these is that he is not seeking to invest accumulated capital; instead, he is seeking to accumulate capital by the allocation of current income to an investment medium—in this case, equity securities, which provide him not only the prospect of compound accumulation, but also a hedge against inflation and depreciation of the value of the dollar. The other characteristic is that in the majority of instances the contractual planholder is not generally accustomed to investing in securities; he does not have a brokerage account and would not be likely to do so had he not been sought out by a salesman, and had the advantages of equity investing explained to him.

The SEC's statement that 3 to 4 hours per sale are required support this thesis.

That contractual plans are sold on an honest and forthright basis should be readily apparent from the fact that from 1940 to the end of January of this year, of a total of 3,656 complaints with respect to securities matters received by the National Association of Securities Dealers, only two pertained to contractual plans. The SEC would have you believe to the contrary by its constant allegations, including those made at these hearings, that the front-end load induces "high pressure" selling, although it has failed to substantiate this claim with any evidence at all.

Despite the fact that, as the statistics referred to above show, the losses incurred by planholders who terminate their plans in the early years are very small in comparison to the profits realized by or accrued to the large majority of planholders, the industry has been concerned with methods of preventing losses resulting from early terminations. Although dollar losses may be small, they can still hurt when the cause of the early liquidation of the plan is financial stress, rather than a mere change in investment strategy, and although, as I described earlier, and I think this is important, planholders have the right to withdraw up to 90 percent of the liquidation value of their shares and to reinvest an equivalent amount without additional sales charge at a later date, some planholders in financial stress do not feel they will have such funds available in the future to reinvest and therefore terminate their plans. The President directed his concern to individuals who suffer financial stress in his special message on consumer protection delivered earlier this year when he said of investors of modest means in contractual plans:

They may face a substantial loss if financial difficulties force them to withdraw from the plan at an early date.

Before the SEC bill was introduced in Congress, members of the Association of Mutual Fund Plan Sponsors asked Benson & Benson, Inc., of Princeton, N.J., to conduct a survey to determine what proportion of planholders who terminated in the early years of a plan at a loss really did so due to financial stress, and how many terminated merely because they chose to put the money to some other use. We asked Prof. Herbert Arkin, chairman of the Statistics Department of the Bernard M. Baruch School of Business and Public Administration in New York, to establish the criteria for this survey before it was undertaken and to analyze it for us afterward.

The summary results of this report and analysis are most illuminating. They show that only some 45 percent of those who liquidated early at a loss can properly be included among those who were forced to terminate because of financial circumstances. As Professor Arkin calculates it in the sample in this particular survey, this amounted to only some 4½ to 5 percent of all contractual planholders who initiated plans within the period studied. The next paragraph shows that in a different survey group the figure came to 8 percent.

The industry has recognized that measures should be taken to minimize early plan terminations and consequent losses, but the SEC's proposal to abolish contractual plans, with the consequent denial to millions of people of the benefits of such plans, is certainly no remedy at all. The remedy is to be found in the screening of prospective planholders in order to be sure that purchasers of contractual plans understand, and are capable of achieving, the discipline required during the early years to keep up their payments. The remedy is to be found in devising methods of promoting persistency and of reducing the numbers of those forced to redeem in the early years. Members of the industry have instituted programs along these lines which I would like to describe briefly to you.

Each member of this Association of Mutual Fund Plan Sponsors insists that every applicant for a contractual plan answer a series of questions designed to determine for himself whether the contractual plan is in fact a suitable investment medium to meet his financial and personal circumstances and whether, in view of his other commitments, he considers himself able to meet the schedule of payments he undertakes to make. The investor confirms in writing his understanding that he will incur a loss if he discontinues his plan in the early stages at certain times and under certain circumstances, and that he must take into account his financial ability to continue his plan through periods of low price levels.

Each member of this association gives the plan purchaser an absolute right, within 30 days after the acceptance of his application, to cancel the transaction and obtain a refund of the entire amount of his initial payment. This right is made clear in a letter sent by the sponsor company to every plan purchaser something that you will not find in any other part of the financial world.

Some companies go further and provide that if an investor does not make his second payment within 60 days after its due date, he will be given another opportunity to terminate his plan and obtain a refund of the entire sales charge he has paid.

I referred earlier to the fact that under a plan instituted by one plan sponsor, First Investors, 69 percent, almost 70 percent of a group

of First Investor's plan holders who had become "inactive"—that is fallen behind in their payments—were reactivated by a follow-up technique employing a series of five letters. Interestingly enough, the average payment made by these plan holders on reactivation was almost twice the regular monthly payment under the plan.

The industry has achieved a great deal by the measures outlined above and should be given the opportunity to do more. We are confident that any problems in the industry can be solved by regulation, and we have always been eager and willing to cooperate in this endeavor.

Against the background of the facts I have described to you, I must say to you in all sincerity, and with the deepest respect for the integrity of the agencies of our Government, that the SEC proposal represents a complete abdication of its regulatory responsibility. It offers a drastic and simplistic solution for the task of effectual regulation which is the function and the obligation of the Commission.

More than 3 years ago, following the publication of the report of its special study which was transmitted to the Congress by the SEC, we filed with the Commission this extensive statement of our position, our problems, our measures for solving them, and the character and merits of our product and our performance. We concluded that presentation by this open invitation to the SEC:

We do not believe—

And we mean that we do not believe—

that our business is perfect. We are not so deluded as to think that it is beyond improvement. We are quite willing to discuss with the Commission any reasonable suggestions for improvement of our methods and operations.

We have been prepared, and we are still prepared, to cooperate sincerely and earnestly with the Commission in solving any regulatory problems that it think may exist. That presupposes, of course, that our business itself will continue to exist; and I am confident in that supposition because I am satisfied that the SEC has given you no sound reason to conclude that it should be destroyed.

Finally, let me conclude with an observation concerning the marketing of services, particularly financial services. It is axiomatic that in this and in every business and in every enterprise that higher compensation is one requisite for attracting and holding higher caliber personnel. In our business, this axiom is the key to better public service. The SEC has proposed a unique concept; namely, that we upgrade our sales force, the people to do the job on the firing line, by the device of reducing their compensation.

Thank you.

Mr. Moss. Mr. Day.

STATEMENT OF J. EDWARD DAY

Mr. DAY. Mr. Chairman and gentlemen, I appear here today as an expert witness retained by the Association of Mutual Fund Plan sponsors to support their opposition to H.R. 9510 and H.R. 9511 and particularly their opposition to the proposed abolition of the so-called front-end load.

My remarks will be devoted principally to the close analogy of the contractual plan sales and sales compensation pattern to the long-

established, highly successful commission system for merchandising life insurance.

First, let me summarize my professional qualifications to discuss this life insurance aspect.

From 1950 to 1953 I served as insurance commissioner of Illinois in the cabinet of then Gov. Adlai Stevenson. During that time I was elected vice chairman of the Life Insurance Committee of the National Association of Insurance Commissioners and also served as chairman of that association's midwestern zone.

Following my term as insurance commissioner of Illinois, I became a senior officer of Prudential Insurance Co. of America, one of the two largest life insurance companies in the world, first, for 4 years, as one of the top members of their law department and thereafter, for another 4 years, as senior vice president in charge of the 13-State western region. In the former capacity I was active in working out methods for issuance of variable annuities by life insurance companies. In the latter capacity my responsibilities included direction of life insurance sales with supervision of over 4,000 life insurance agents.

I have written a number of published articles on life insurance subjects, and am a member of the board of directors of several insurance companies. I am frequently called on to make speeches to insurance industry groups on recognition and motivation of life insurance agents.

THE FRONT-END LOAD

The front-end load used by mutual fund contractual plans typically involves deducting 50 percent of the first year's payments for sales load.

On a 10-year, 120-payment, \$25 per month plan, which is a very common dollar amount for contractual plans, the 50-percent front-end load would typically equal \$150.

Under the law, if a 50-percent front-end load is used for the first year, then the sales charge deducted in each subsequent year, for a 10-year plan, for instance, cannot exceed 4.45 percent per year. The effect of the lower loads in subsequent years is that the investor who is in the plan the full 10 years ultimately pays approximately the same total sales load he would have paid had he invested directly in the underlying mutual fund shares with no front-end load.

It is important to realize that only about half of the total front-end load—one-half of \$150—or \$75—in the \$25 a month plan I referred to—goes to the salesman who actually talks to the customer and makes the sale. The balance is used for other expense, such as recruiting, training, and supervision of sales personnel, advertising, home office overhead and profit.

The mutual fund contractual plan salesman thus earns about 25 percent of the first year's payments, in contrast to the 55 percent which, as I will describe, is typically earned in the first year as a minimum by the life insurance agent on the sale of an ordinary whole-life policy. This 55 percent is, again, only about half the total first year sales expense on a whole-life policy, the balance being used for incentive compensation of the field manager or general agent and for other first year field and home office sales expense.

THE IMPORTANCE OF SALESMEN

Before I pursue the significance of the analogy to life insurance, let me state certain fundamental points of personal conviction:

1. Certain worthwhile products, particularly in the area of financial protection, do not sell themselves.
2. The public is better off, in the long run, by having these worthwhile products sold to them.
3. The salesman plays a valuable role in our present-day society.
4. People who are doing the selling must be adequately compensated.
5. The more nearly adequate the compensation of the salesman, the better the chance that people of high quality will be attracted to the job and that the salesman will acquire the training, give the time, and practice the fairplay required for the most conscientious approach to the prospect.
6. The cost of providing such compensation to the salesman must be paid by the person purchasing the product.
7. The attack by the SEC on the front-end load principle has implications far beyond the mutual fund industry.
8. This attack shows a lack of appreciation of and, as a result, unjustified stultification of the whole system of providing incentive compensation to salesmen.
9. The analogy between selling methods for life insurance and for investment plans is more valid today than ever because, in response to public demand, there is an increasing tendency to blend these two types of products.
10. There is social value in structuring any type of savings plan so that the saver is discouraged from withdrawing his payments before he completes the program.
11. It takes character on the part of a buyer to put aside some of his income on a regular basis rather than spending it all. This is particularly true where the individual has limited discretionary income and does not find it easy to undertake a savings program on his own initiative. Developing and bringing about such a character decision requires individual solicitation and service. Selling any capital accumulation plan serves a valuable social purpose not only in improving the individual situation of the saver but in helping to add to the national reservoir of capital.
12. In this country hundreds of thousands of salesmen share directly in our profit system by selling on an incentive compensation basis. Selling for profit—on a commission or incentive system—is recognized as a challenging and satisfying way of life for independent-minded men who have the courage to take a chance on themselves. Not everyone wants to earn his bread protected by an umbrella of tenure, regular hours, and a safe place on the organization chart.
13. If some paternalistic "mama knows best" group could regulate every transaction by which products or services are sold by salesmen working on an incentive basis, such a group could no doubt prove that every such product or service could be bought more cheaply by some other method. Such a group could no doubt also prove that purchasers are fools ever to pay the list price for everything or to do their shop-

ping at other than discount houses. The group could probably prove in addition that car buyers are being victimized by having to buy automobiles through dealers and that everyone should be able to buy Chevrolets direct from Detroit.

14. The attack on selling commissions in this proposed legislation evidences an attitude which concerns me. When I was Postmaster General, people frequently wrote to me wanting me to do something to put an end to privately-owned stamp vending machines in drug-stores, newsstands and airport waiting rooms. I was always amazed at these people, many of them stalwart free enterprisers, who objected to paying 1 or 2 or 3 cents over the face value of the postage stamps on a 10-cent or 25-cent transaction, for the convenience and service of having the stamps available for them to buy when and where they wanted them. In our supposedly profit-oriented economy there are too many people who seem to resent it if someone makes some money—even though the amount earned is reasonable in relation to the service rendered.

Over the past hundred years tens of millions of Americans have purchased individual life insurance policies. The overwhelming majority of these people or their families have been better off for the purchase of these policies. Practically none of these policies sold themselves. They were sold by agents—or, as they prefer to be called, by life underwriters.

It is a truism in the life insurance business that a prospect never comes into the office asking to buy a policy. Efforts have been made and are still being made from time to time to merchandise individual life insurance by mail or by newspaper and magazine ads without a person-to-person confrontation between salesman and prospect. But these efforts have on the whole been notably unsuccessful.

There is a particular situation which illustrates dramatically that the salesman is essential to life insurance merchandising. In three States legislation has given savings banks authority to write life insurance. These States are New York, Massachusetts, and Connecticut. These savings bank plans are operated without agents on the theory that purchasers will come into the bank to purchase an individual life insurance policy over the counter.

Compared to the new business written over the years by life insurance companies using agents, the results achieved by the savings bank plans have been quite limited.

The Massachusetts savings bank life insurance plan, for example, was started in 1907. For the year 1966 this plan, participated in by 36 banks in the State, had only \$18.4 million of total premium income from individual policy life insurance in force despite somewhat lower costs to the purchaser because of the elimination of agents' commissions. This compares with a total of over \$13 billion of premium income from individual life insurance policies for the life insurance industry as a whole in the United States in 1966.

The New York plan is more recent, having been started in 1938, but it has a much larger number of savings banks participating and in 1965 had less than \$19 million of premium income from individual policy life insurance.

LOADINGS IN LIFE INSURANCE

For the purposes of this statement it is not necessary to go into the details of the varied and complicated arrangements for compensation of agents who sell individual life insurance policies for commercial companies using the agency system. For any life insurance company licensed in New York State the maximum commission which can be paid—and the usual commission which is paid—to the agent on a sale of an individual policy of life insurance is 55 percent of the first year's premium. This would normally be for a whole life ordinary insurance policy in contrast to a term insurance or endowment policy. For companies not licensed in New York the commission paid to the selling agent on an individual whole life insurance policy typically is 65 percent, and sometimes is as much as 80 percent of the first year's premium.

This commission to the insurance selling agent is net to that agent. There are in addition other direct selling expenses such as incentive overrides to field sales managers and assistant managers or to general agents, advertising and home office sales expense. Total selling expense on a whole life insurance policy sold by a company doing business in New York will customarily run as high as 100 percent of the first year's premium and for companies not doing business in New York will run as high as 120 percent of the first year's premium.

It is a familiar fact to any purchaser of life insurance that an individual whole life policy will typically not acquire any cash surrender or loan value during the first year after he takes it out and that such cash surrender value will be small in relation to the amount paid in for several years after the original issue of the policy. The cash surrender value represents the current savings element of a life insurance policy which is available to be withdrawn or borrowed by the policyholder.

SIMILARITY BETWEEN WHOLE LIFE INSURANCE POLICIES AND CONTRACTUAL PLANS

I do not claim that a contractual plan and a life insurance policy are identical products. I do not claim that they are bought for identical reasons. But I do say that they are both products that do not sell themselves, that in both cases people are better off for having bought them, and that in both cases they will not be bought unless a salesman with a financial incentive goes out and makes the sale.

Life insurance policies and mutual funds sold under a contractual plan each have a special feature which makes a purchaser willing to have substantial deductions made from his payments for selling expense. In the case of the life insurance policy, this special factor is the death benefit with the possibility of a very high dollar payment to the beneficiary in the event of death, particularly during the early years.

In the case of the mutual fund, the special feature is the expert investment management, the diversification of investment, and the chance that the accumulated contributions will increase substantially in market value.

In this connection, it can be noted that in the period from January 1, 1956, to September 30, 1966, with capital gains reinvested and income

dividends taken in cash, the net asset value of the average balanced mutual fund increased 94.7 percent and the net asset value of the average growth mutual fund increased 151.3 percent.

Thus, there is a remarkable similarity between whole life insurance policies and the mutual fund contractual plan. Both are a means of achieving financial protection by systematic savings. It must be recognized that the whole life insurance policy does not merely provide death benefits. It also is a method of saving on a regular, periodic basis. If death benefits were the only reason for life insurance and savings were not a significant element, then everyone would have term life insurance and pay the much lower rates for term insurance.

But the fact is that most ordinary life insurance protection provides for the accumulation of the cash value of the policy as the years go by, enables the policyholder to obtain loans from the insurance company, and also provides for payments to the policyholder during his old age. These provisions could not be in the policy unless the policy had some value or equity.

Since most policyholders do not die until they reach old age, in the average and typical case a fundamental purpose of a whole life insurance policy is, in fact, a planned method of savings. That is a key purpose of a whole life insurance policy. It is the objective of the mutual fund contractual plan in which an individual also makes monthly payments for a stipulated period of time.

THE UNSOUNDNESS OF THE SEC'S ARGUMENT AGAINST THE LIFE INSURANCE ANALOGY

The SEC, in its memorandum commenting on testimony on this legislation before the Senate Committee on Banking and Currency, attempted to avoid the impact of this life insurance analogy. Understandably the SEC cannot admit that the analogy is valid for if they did their whole case for trying to destroy contractual plans would collapse.

But, with all due respect, I feel that the SEC's attempted rebuttal in regard to permanent life insurance is inconsistent even on its face. The SEC says that:

The buyer of a mutual fund contractual plan * * * seeks to save money * * *. * * * the front-end load does much to defeat the planholder's basic objective: saving and investing.

Later on, the SEC rebuttal says that:

To keep the premium (on permanent life insurance) from rising as the assured ages, savings must be accumulated from the early premiums.

It is obvious then that less goes into such accumulated savings on permanent life insurance as a result of the front-end load on life insurance sales. Therefore, to paraphrase the SEC, we might say, if we were adopting their point of view:

The front-end load on life insurance likewise does much to defeat the purchaser's saving objective.

The SEC in its rebuttal memorandum completely ignored the fact that there is full disclosure of selling costs in contractual plans and none at all in life insurance. To say that the front-end load, which the contractual plan purchaser is told all about, defeats the planholder's

basic objective, amounts to saying that people are too dumb to be trusted to make their own decision as to an objective even when all the pertinent facts are given to them in writing. That does not strike me as a particularly democratic attitude.

I doubt if the public really expects to be led by the hand and mothered every minute by Government particularly when all the pertinent facts are available to permit them to make a choice.

There are other important reasons why the life insurance analogy is valid here and must be dealt with.

First, annual premium deferred annuities now sold by life insurance companies are sold with a front-end load of as much as 50 percent. They involve no death benefit. They are merely accumulation plans during the period before annuity payments begin. There are well over a million of these individual annuities in force, not too many less than there are contractual plans. I would like to know how the SEC distinguishes the front-end load on these annuity plans from the front-end load on contractual plans.

Second, many mutual fund contractual plans are sold with completion life insurance. This combination product is, in effect, a life insurance endowment policy with cash values invested in common stocks.

Third, more and more of the leading life insurance companies are moving into the selling of variable annuities, which are life insurance company annuities backed by investments in common stocks. Many of these variable annuities are offered under a front-end load plan. The decision by many of the companies in the life insurance industry to move into selling common stock investment plans confirms and recognizes the public's interest in and demand for contractual plans such as we are talking about here.

Fourth, many experts feel it will not be long before life insurance companies generally will be selling variable life insurance with the death benefit and cash values varying to reflect investment results of investments in common stocks. Granted, the primary motivation for purchasing life insurance might very well be support for dependents. However, that objective can be met by the purchase of term life insurance which provides pure insurance protection with no savings element.

The fact is that the cost of providing the pure death benefit on a year-to-year basis—that is, the mortality cost—in a life insurance policy is remarkably low—far lower than most people realize. For a whole life policy issued to a man age 40 at standard rates by a typical large life insurance company, this pure mortality cost—entirely aside from loadings, expenses, taxes, and profit—is only \$1.20 per \$1,000 of life insurance coverage in the first policy year. For this policy the mortality cost is only \$4.40 per \$1,000 of coverage in the 10th policy year when the man is age 50. The premium for this policy is \$20 per \$1,000 of coverage each year. Since there is no cash value at the end of the first year, 94 percent of the gross premium is available for expenses, including commissions, and for taxes and profit. Actually, more than this 94 percent of the gross premium on the policy involved is typically used, even by conservative life insurance companies, for first-year expense.

To meet total first-year expense, which will often be over 100 percent of the first year premium, the company, in effect, borrows more money

from its surplus or from the pool of funds built up by older policies. As a result, and because of the lapse factor, a life insurance company often will not recoup its investment in a new policy for periods ranging from 6 to 12 years.

Most of this first-year expense is selling expense. The reason I emphasize the willingness of even the most conservative life insurance companies to invest so much in selling expense is to show that in the life insurance business the front-end load principle is universally accepted as essential.

In addition, the low proportion of the first-year life insurance loading which is made up of the mortality cost proves that the SEC has by no means succeeded in dismissing the contractual plan—mutual fund analogy when it says the purchasers of life insurance “immediately receive the full measure of the contemplated death protection.” The portion of the early year premiums that go to providing that death protection under whole life policies is very small indeed.

The SEC's report on investment company growth attempts to distinguish the life insurance analogy by arguing that while there is a very large difference in the compensation of the salesman as between a contractual plan and a voluntary plan, there are only very moderate differences in commission to the life insurance salesmen depending on the type of policy he sells. The report premises this argument on the unsubstantiated theory that customers for life insurance decide to spend a certain annual amount on premium rather than being interested in a given face amount of coverage.

The fact is that for a \$10,000 policy to a standard risk age 40, the agent's first year commission will, for a typical New York-licensed company, be \$29 if the policy is a 10-year term, \$126 if it is whole life, and \$195 if it is a 10-year endowment.

It borders on the ridiculous for the SEC report to say (p. 246) that “the front-end load effectively precludes many dealers and their salesmen from giving adequate sales presentations of level load accumulation plans to persons of modest means.” This is like saying that the substantial first year commissions paid by New York Life Insurance Co. precludes their agents from giving to prospects adequate sales presentations of savings bank life insurance plans under which no commissions at all are payable.

Just who would be compensating these mutual fund and life insurance salesmen for telling prospects about alternative plans which provide no margin or negligible margin for compensation of the salesman?

Does the SEC claim that prestige department stores should pay their salesmen to tell the customers they could get most items cheaper at Sears Roebuck?

ADEQUATE COMPENSATION FOR SALESMEN

The SEC report never faces up to the question of adequacy of compensation for salesmen. It is the position of the contractual plan industry that the front-end load is the only means by which adequate sales compensation can be achieved for contractual plans. The SEC does not deny this. It does not present an alternative method for providing adequate compensation.

The SEC acknowledges that high turnover rates among salesmen are chronic in the securities industry generally and "particularly acute for the large contractual plan sales organization."

It is also recognized that about two-thirds of the contractual plan salesmen earn less than \$1,000 a year in the securities business. A study of the turnover of sales personnel in 1961 revealed that over 40 percent of the sales force were hired and almost as great a percentage ceased working for the sales organizations during that year. Thus, in view of the high turnover of personnel and the low compensation for salesmen, it would seem evident that a substantial reduction of the sales load would only further aggravate the problem.

High turnover rates and low compensation have also been prevalent in the life insurance industry, which also utilizes the front-end load principle. This is no doubt due in large part to the fact that selling is hard work when the selling is other than to customers who come in seeking to buy the product.

According to statistics prepared by the Life Insurance Management Association, 75 out of every 100 who enter the business of selling life insurance fail to make it past the first 2 years.

The discussion of the compensation problem in life insurance selling has been frank and realistic. Some of the foremost leaders of the life insurance industry have advocated the revision of expense limits in the New York insurance law so that salesmen can be paid more than 55 percent of the first year's premium. One of these top leaders is Leland J. Kalmbach, chairman of the Massachusetts Mutual Life Insurance Co. In a speech in December 1964, when he was serving as chairman of the prestigious life insurance trade association, the Life Insurance Association of America, he said:

There has been a steady decrease during recent years in the proportion of new Ordinary [life insurance] business sold by companies operating in the State of New York ***.

I might interpolate to point out that if a company is licensed in New York, the commissions it can pay in any State have to be in accordance with the New York limits. Northwestern Mutual, a Wisconsin-domiciled company, since it is licensed in New York State, can only pay the New York permissible limits on insurance it sells in California or New Mexico.

The statement that Mr. Kalmbach made:

There has been a steady decrease in the proportion of business sold by companies operating in the State of New York.

All of this suggests that the New York limitations on compensation are having an adverse effect on the rate of growth of the companies subject to those limitations.

Other life insurance leaders have been saying the same thing.

The New York Association of Life Underwriters has been working diligently to get the New York Legislature to increase the limits on compensation of life insurance salesmen.

CONCLUSION

Life insurance, like contractals, has always had its detractors.

Every year or so someone comes out with a book that claims that permanent life insurance is overpriced, is a poor buy, and that every-

one should "buy term and invest the difference." I have read many of these things. I am familiar with the arguments of the hecklers, and I have long been familiar with the amount of life insurance loadings, but I have most of my own savings in permanent life insurance. Needless to say, I have paid the full loadings on all my purchases of life insurance. Although I am fairly good most of the time at self-discipline and am not poverty stricken, I am as susceptible as most people to the urge to spend everything that comes in and, therefore, the forced savings aspect of life insurance is of real substance to me.

I am utterly sincere when I say, as an individual and not just as an expert witness, that the far-reaching implications of the attack in this proposed legislation on the whole concept of sales commissions concerns me deeply.

Let me explain that briefly, Mr. Chairman. You may be wondering why I talk so much about life insurance and what these implications are that I am referring to.

In my opinion, if the Congress of the United States takes the position that the front-end load principle is immoral and indefensible, it has implications far beyond this bill. It strikes at hundreds of thousands of salesmen who earn their pay under front-end load plans. A major portion of those salesmen are life insurance men.

If Congress says this type of compensation is improper and unjustifiable, other regulatory agencies, including those having jurisdiction over insurance, are liable to decide that they need to take action.

For years I have tried to do my bit in defending the salesman against those who seem to be saying he does not play a worthwhile or justifiable role in our society; in defending him against those who would just as soon drive a lot of salesmen with low or moderate incomes completely out of business.

We are moving here, it seems to me, to a form of paternalism that demeans the rank and file citizen. This bill seems to say to John Doe that even when all the facts and figures are disclosed to him, he is not to be trusted to make an intelligent choice among alternatives—that he must have the choices limited by a Government agency that decides what is good for him.

I cannot buy that. Even the Washington Post cannot buy it.

I do not think we are ready to read salesmen, who sell on commission, out of our society.

Thank you, Mr. Chairman.

Mr. Moss. Mr. Day, let me tell you something. I was in selling as the first effort at making a living, and I sold on commission for a long time. I was a sales broker before coming to the Congress. I have no desire to drive them out of business, but I must candidly state that I am most singularly unimpressed by your statement today.

I think that it has not constructively dealt with the subject before us. The fact that you have an outrageous turnover in the insurance industry does not convince me that it is justified, and there are very thoughtful persons in the industry, leaders in the industry, who feel that the failure to come up with a more workable system of compensation, not the level, the level attracts them, but the need to better compensate them during an inadequate period of training, and to improve the agency system so that the whole philosophy is not to go out and recruit so that you have, we will say 25 percent are coming, 50 percent

are working and 25 percent are going, because you know you will pick up a few of their relatives and a few of their friends on some policies and get some business, but it is very minimal income that they are going to earn during that period. I do not think that justifies it.

If you want to you can characterize it as "mamma knows best" or paternalism, but I do not think it is a fair or adequate system of compensation, and I do not think increasing the amount which might be permitted would cure the basic defect in the sales organization of most life insurance agencies.

And I am not convinced that the testimony has indicated it would solve the problem of turnover here in the sale of front-end load systems.

Now Mr. Kostmayer, you made some very interesting allusions to the makeup of the population in my State. I think it is younger than the average in its overall population makeup, not older.

I am going to do a very careful job of a cross section of the population of California, and ask permission at the appropriate time to include it in this record, but I do not think it will bear out your conclusion that the phenomenal success of mutual funds there is because of those who are retiring there. I think most of those retiring in California come there with retirement income. They are not the investors.

Now I have some knowledge of the area you represent, where there is a very good market for mutual funds, an excellent market, and I do not think it is being sold to the older folks only. I think there are a lot of young investors in it. So I cannot accept that as being an accurate analysis of the reason for the success in California, notwithstanding the fact that a front-end load has been foreclosed.

I have a number of very close friends in this business, very successfully, and I will ask them about some of their age groupings and try to get a little fuller understanding. But it would certainly be contrary to your statement in my opinion.

When I served in the legislature there, I used to be told all the time that our great problem there was that the people who came there to retire were so poor that they were all on relief, which hardly matches the picture you have drawn of these older folks who come in and start to buy mutual funds.

I think it is far more helpful to the committee if, in citing things of this type, there be a careful research, so that it becomes fully reliable for us.

We are seeking the facts. We are not wanting to hurt anyone here on this committee. I do not think there is a member of it who has any desire to injure needlessly any segment or sector of the American economy.

In your statement, Mr. Kostmayer, you also stated that you recognized the need for measures to be taken to minimize early plan terminations and consequent losses. I would like to know what suggestions have been made to the Commission and what suggestions you might offer this committee to minimize these losses from early plan terminations.

Mr. KOSTMAYER. Several of the things, Mr. Chairman, that I mentioned in my formal paper have been suggested to the Commission and are recommended to the committee for consideration. We think

it would be desirable to have all plan sponsors required to offer the 30-day unconditional refund. We think that a 30-day period in which the new buyer can think it over his choice, and recover if you will, sir, from any undue persuasiveness on the part of the salesman can be a wholesome factor in continuity of payments.

We suggest the possibility that the 60-day refund to people who do not make their second scheduled payment on time might be worth your consideration. We believe that measures such as direct mail campaigns and possibly others that could be developed be utilized throughout the business, to reactivate accounts as soon as those accounts fall behind in their payments.

I think this an area in which we certainly have room for improvement, and in which we have made some improvement, but certainly ought to make more.

It is almost human nature for people to neglect payments when there is something that is present and available which is more attractive to spend money for. We think this area deserved attention and this was actually called to our attention primarily by the SEC's investigations, but we think that these sort of administrative procedures, given a fair chance to demonstrate their effectiveness, might do much to correct the things of which you are critical.

Mr. STUCKEY. Will the chairman yield for a question?

Mr. MOSS. Yes, sir; Mr. Stuckey.

Mr. STUCKEY. This has been one of the objections that the SEC has raised to the front-end load—your high-pressure selling and all—and you yourself are saying that this is a recommendation that you would like to see done. Isn't it pretty much a common practice now that most of your funds do have a 30-day unconditional refund offer, just exactly what you are referring?

Mr. KOSTMAYER. Yes, Mr. Stuckey; I would say that probably plan companies representing 70 percent of the business now make this offer.

Mr. STUCKEY. Then the question is: How long does it take for the effects of overpersuasiveness to wear off—10 days, 60 days, 90 days? In other words, if this is a common practice now, it looks like to me that in 30 days he can get his refund back, 60 days or even 90 days, that the pressures would be off of him in that length of time. I agree with you in your recommendation, but there again aren't most of the mutual funds doing this now?

Mr. KOSTMAYER. Most are doing it. but it is not required that they do it, and we think it might be wholesome if all were required to do it.

Mr. STUCKEY. Isn't this something that could be self-regulatory, or even for that matter written in? I am in complete agreement with you.

Mr. KOSTMAYER. I think that is certainly a possibility; yes, sir.

Mr. STUCKEY. But it is fairly common practice.

Mr. KOSTMAYER. It is fairly common practice, and I think very helpful.

Mr. STUCKEY. If 70 percent of your companies are doing this now, has there been any public outcry, objections as to high-pressure selling?

Mr. KOSTMAYER. No, sir; there have been no complaints about high-pressure selling or about any other aspect of the contractual plan business except from the SEC. There have been no public complaints.

Mr. STUCKEY. Let me ask you this then. Do you have any idea of the percentage of contractual plan sales, and there again we are going back to your high-pressure selling, do you have any idea of the percentage of contractual plan sales that result directly from recommendations by say satisfied planholders?

Mr. KOSTMAYER. Yes, sir; I think I can give you pretty general figures based on my own company.

Mr. STUCKEY. In other words, this is getting out of the pressure selling. This is just purely from recommendations.

Mr. KOSTMAYER. Right.

Mr. STUCKEY. From those who are satisfied.

Mr. KOSTMAYER. I would say that people who either buy because they are buying a second time or buy because they have been—a salesman has been recommended by someone who already owns the plan constitute three-quarters of all of our volume. Does that respond to your question?

Mr. STUCKEY. Yes.

Mr. MOSS. Mr. Roach, among other items which the Securities and Exchange Commission has raised is the question of the use of brokerage and portfolio transactions to provide an extra commission for dealers who distribute investment company stock. This, as you know, is described as a give-up. It is my understanding that your members have your own sales organization so that this practice is not present. I also understand that some of your members, and I think you yourself are members of the Pacific Coast Stock Exchange.

Mr. ROACH. That is correct, sir.

Mr. MOSS. Just how do you treat the brokerage or commission on portfolio transactions? Does it accrue to the advantage of the fund?

Mr. ROACH. Under the investment advisory agreement between United Funds, Inc., and Waddell & Reed, Inc., the compensation otherwise payable by United Funds, Inc., to Waddell & Reed, Inc., is reduced by an amount related to the "net income" of Kansas City Securities Corp. Kansas City Securities Corp. is a subsidiary of Waddell & Reed, Inc., and is a member firm of the Pacific Coast Stock Exchange through which a portion of the portfolio transactions on behalf of United Funds, Inc., and others are executed on that exchange.

For the purpose of the agreement the net income of Kansas City Securities Corp. is determined in accordance with generally accepted accounting principles except that in such determination there is subtracted provision for Federal income taxes as if Kansas City Securities Corp. were to file a separate Federal income tax return, whether or not Kansas City Securities Corp. has filed or is to file such a separate return.

The total amount of management fees payable by United Funds, Inc., to Waddell & Reed, Inc., for each month is reduced on an annual basis by an amount equal to the higher of (A) 100 percent of the net income of Kansas City Securities Corp., resulting from commissions and discounts on portfolio transactions executed by Kansas City Securities Corp., for United Funds, Inc., since the beginning of the then current fiscal year of Kansas City Securities Corp., or (B) 50 percent of the net income of Kansas City Securities Corp., from all sources since the beginning of its then current fiscal year. In computing (A) above, the expenses of Kansas City Securities Corp., for the periods in question are allocated in the same ratio as commissions and dis-

counts on portfolio transactions executed by Kansas City Securities Corp., for United Funds, Inc., bear to the gross revenues and income of Kansas City Securities Corp., from all sources. Reductions under either (A) or (B) are made monthly after giving credit for the aggregate amount of previous reductions, but no adjustment is made in any month where the aggregate amount of previous reductions exceeds the higher of (A) or (B) for the period then elapsed since the beginning of the then current fiscal year of Kansas City Securities Corp. The reduction in the management fee has been computed on the basis set forth above since September 1, 1966.

Mr. Moss. This is for the purpose of reducing the management fee charged against the fund; is that correct?

Mr. ROACH. That is correct.

Mr. Moss. As members of the Pacific Coast Stock Exchange, can you deal with the third market in making portfolio purchases or sales?

Mr. ROACH. Yes.

Mr. Moss. Mr. Keith.

Mr. KEITH. To what extent do you use the third market?

Mr. ROACH. In the past several years, as you know, there has been an increasing use of the third market, and I believe that we have used it about in the same proportion that other similar companies have used the third market.

Mr. KEITH. That isn't very responsive.

Mr. ROACH. Well, it isn't very responsive, but I can provide precise figures.

Mr. KEITH. Can you tell me roughly and then perhaps provide more precisely at a later date?

Mr. ROACH. In what—

Mr. KEITH. Could you give us a percentage estimate?

Mr. ROACH. This would be a guess, and I would prefer to provide the precise amount; but I would say somewhere between 5 and 10 percent of our transactions would be third-market transactions, but I would like to have an opportunity to find out precisely what that is, and give you a letter and let you know. This is not an area in—

Mr. Moss. Would you like to hold the record at this point so we can include that letter in context then with the hearing.

Mr. ROACH. I will be very happy to do so.

Mr. Moss. All right; fine.

(The information requested follows:)

* WADDELL & REED,

Kansas City, Mo., October 23, 1967.

In re H.R. 9510 and H.R. 9511 report of proceedings before the Subcommittee on Commerce and Finance.

Hon. JOHN E. MOSS,
The House of Representatives,
Washington, D.C.

DEAR Mr. MOSS: In response to the question, Lines 19 and 30, Page 446 of the above record, "To what extent do you use the third market?" and "Could you give us a percentage estimate?", please be informed that for the nine month period from January 1 to September 30, 1967, the volume of third market transactions transacted by Waddell & Reed, Inc., were as follows:

1. Stated as a percentage of total brokerage commissions—6.58%.
2. Stated as a percentage of total dollar transactions—10.62%.

Very truly yours,

CORNELIUS ROACH,
General Counsel.

Mr. KEITH. One note, Mr. Roach. You say, and just to set the record straight, I recognize that you do provide a tremendous opportunity for people to get into equities, but not all these people who do buy mutual fund plans would necessarily spend what was left over.

Mr. ROACH. Of course.

Mr. KEITH. You say on page 2 "Those investors would otherwise have spent as disposable income."

Mr. ROACH. It should have been a qualification of possibly rather than flat.

Mr. KEITH. Generally speaking they might end up with life insurance.

Mr. ROACH. They might.

Mr. KEITH. They might end up in cooperative banks or savings and loans.

Mr. Kostmayer, you mentioned on page 3 "In addition the planholder has the valuable right to withdraw up to 90 percent of the current liquidation value in mutual fund shares." Do you charge any interest on that?

Mr. KOSTMAYER. No, Mr. Keith.

Mr. KEITH. Is that so?

Mr. KOSTMAYER. Right. Of course, I should point out to keep this perfectly accurate that when money has been withdrawn——

Mr. KEITH. It is no longer working.

Mr. KOSTMAYER. Right.

Mr. KEITH. It is not a loan.

Mr. KOSTMAYER. It is not a loan.

Mr. KEITH. It is simply they can redeem up to 90 percent.

Mr. KOSTMAYER. That is correct.

Mr. KEITH. So they don't get the earnings. I misunderstood that. It isn't at all parallel to a life insurance company allowing the policyholder to borrow the cash value.

Mr. KOSTMAYER. No; it is not really the same thing as a policy loan, not at all.

Mr. KEITH. I have a note here we are not so much concerned about the good guys. What about the others. This is along the lines of Mr. Stuckey's point. Roughly 70 percent of the people in this business give their customers an opportunity to change their minds after 30 days.

Mr. KOSTMAYER. That is correct.

Mr. KEITH. It is probable that the people who practice high-pressure tactics are the same kind of people who would not be eager to refund the money.

Mr. KOSTMAYER. I don't think it really relates to that, Mr. Keith, so much as the fact that certain of the big plan sponsors have chosen, for perfectly good reasons of their own, not to join this association, and the 30-day offer of refund is a requirement of membership, and I have no reason to assume that they——

Mr. KEITH. In other words, all of your members do this.

Mr. KOSTMAYER. That is correct, sir.

Mr. KEITH. That is a requirement.

Mr. KOSTMAYER. It is required.

Mr. KEITH. And in your view the presence of this requirement is not a deterring factor to others joining the association. There is some other reason if they don't join.

Mr. KOSTMAYER. I have no reason to think that this has been the factor to keep them out, correct, and I certainly have no reason to believe, knowing the natures of the organizations who have not joined, that they have stayed out because they are in fact the bad guys as distinguished from the good guys.

Mr. KEITH. Well, I think that misrepresentation must take place upon occasion, such as overly optimistic portrayals of the benefits of the plan. It does in almost any business. You learn by trial and error as to what salesmen have character, ability.

Mr. DAY. May I comment on that, Mr. Keith, on that point?

Mr. KEITH. Certainly.

Mr. DAY. I think the thing that bears importantly on that is that your contractual plan salesman in a typical \$25 a month plan would collect only the first 2 months payments at the time he makes the sale, so that means he gets \$12, \$6 for each of the payments.

Now it seems to me that it would be poor tactics on his part to use as a typical matter a type of high pressure, misrepresenting salesmanship, so that as soon as he goes away, that is soon going to wear off, and the fellow is going to wish the salesman had never bought the plan, because he is going to end up with only peanuts as far as compensation is concerned.

The salesman has to use the type of sales efforts so that it will stick, and he gets this first year payment, which he only gets after the whole year of payments has taken place, which as you know is somewhat of a contrast to life insurance, where it is very frequent practice to attempt to get the full first-year premium at the time the sale is made. This man typically only gets the commission based on 2 monthly contractual payments.

Mr. SPRINGER. Would the gentleman yield for a question on that?

Mr. KEITH. Yes, certainly.

Mr. SPRINGER. Might I ask whoever is qualified here two questions, which is one question really in two parts. How much of the total salesmen in the country involved in this have front-end load payment, what percent of the total salesmen?

Mr. KOSTMAYER. I think it is difficult, Mr. Springer, to answer it in terms of total salesmen. About 25 percent of all of the mutual fund sales are made with front-end loads, and this comes to roughly some 10 percent of the total volume.

Mr. SPRINGER. But you don't know what percent of the people involved are salesmen in this field?

Mr. KOSTMAYER. No. Mr. Roach, do you have any figures on that?

Mr. ROACH. I would estimate that of the some 90,000 registered representatives who are engaged in the offering or are entitled and authorized to offer mutual funds and contractual plans, of that number, I would say somewhere around 25,000 are actively engaged in offering contractual plans.

Mr. SPRINGER. Between 25 and 30 percent.

Mr. ROACH. That is right.

Mr. SPRINGER. Now what total of all the volume of the sales of mutual funds involve front-end load?

Mr. KOSTMAYER. Numerically it is about 25 percent. In terms of volume it is about 10 percent.

Mr. SPRINGER. In terms of dollars it is 25 percent.

Mr. KOSTMAYER. No; in terms of numbers of people it is about 25 percent, in terms of dollars about 10 percent.

Mr. SPRINGER. About 10 percent.

Mr. KOSTMAYER. Right.

Mr. SPRINGER. Of the total amount of dollars involved in all mutual fund sales?

Mr. KOSTMAYER. I might just add one sentence to that, sir; contractual plan salesmen go out to sell contractual plans with a front-end load. In the process of doing this, they encounter investors who also have cash to invest, and who in turn buy mutual fund shares outright, so that the amount of business that results from contractual plan activity is considerably in excess of the contractual plan business done, but the figures are 25 percent in numbers of people, 10 percent in dollar amounts.

Mr. SPRINGER. Thank you, Mr. Keith.

Mr. KEITH. When somebody starts payments again as a result of solicitation by mail to reinstitute their plans, do they get back in on a first year commission basis?

Mr. KOSTMAYER. That all depends, Mr. Keith, upon when they have stopped making payments.

Mr. KEITH. Let's just say that in the third year——

Mr. KOSTMAYER. Oh, no, sir, they would then go back on the lowered commission that follows the first year front-end load.

Mr. KEITH. Suppose some salesman was given that account to service, and he goes out and as a result of his effort they reinstitute that as an active account?

Mr. KOSTMAYER. In the third year?

Mr. KEITH. In the third year.

Mr. KOSTMAYER. There is no further front-end load. It has been paid and that is over and done with.

Mr. KEITH. Unless he by chance signs up for a new plan.

Mr. KOSTMAYER. Yes, which we would not allow him to do unless he were current in his payments on the old plan.

Mr. KEITH. Supposing that you had an unscrupulous agent, and he said "Well, perhaps you could do better if you went with Aerospace Industries Mutual Plan. You might like that one even better." Is there any switching like that that takes place?

Mr. KOSTMAYER. No, sir, I think there is none because the planholder's reaction to this sort of dishonest approach would be "I'm terribly sorry but I have already paid a front-end load, and I don't want to do it again." I think if there were only level loads that this switching would take place.

Mr. KEITH. Can you buy no-load funds on the installment plan?

Mr. KOSTMAYER. Yes, I think you can buy no-load plans any way you choose to, but you have to make the effort and initiate the activity yourself.

Mr. KEITH. Is there any management company that anticipates direct selling by mail and having a sales commission schedule considerably less than that of the present contractual plan, we will say 3 or 4 percent, and selling it by extensive advertising and mail solicitation?

Mr. KOSTMAYER. I don't know of any, Mr. Keith, which is not a complete answer to your question, but the inhibitions on advertising and

promotion are such that it seems to me unlikely that any serious entrepreneur would undertake this.

Mr. KEITH. The advertisements with reference to savings banks life insurance, are not of a similar sort to those required by the SEC.

Mr. KOSTMAYER. I gather not from those that I have seen.

Mr. KEITH. And it would seem to me to be perhaps, if the SEC's philosophy is appropriate, and I am not yet of a mind that it is, that there should be some advertising to stress the difference between the commission schedules that are available to the man who would like to buy but doesn't really want to entertain a salesman, and so he could be solicited perhaps through the mail and through advertising in the press.

I might say, to draw a parallel, having been in the life insurance business, and I believe I have sold a lot of life insurance for savings banks, because I would make the pitch and the man would buy the idea, and he would go to the savings bank, and I suspect you people in the contractual plan business have sold a lot of mutual funds for those who are not in the contractual end of the business.

Mr. KOSTMAYER. I am sure of it.

Mr. KEITH. And a lot for the no-load funds as well. I recall shortly after I got out of the service that there was a big movement in the Legion to reinstitute national service life insurance, and I appeared before the local Legion chapter and said that this would not be wise, because if the good agent were out there soliciting a veteran, he would be morally obligated to encourage that man to reinstitute his national service life insurance, and inasmuch as most of the prospects were veterans, he would just be doing service work, and he would starve and there would be fewer agents out to sell the idea of national service life insurance. This is an important factor in this particular end of the business, to have these agents or salesmen out, because although only 10 percent of the dollar volume comes, the motivating ideas are perhaps great contributing factors.

Mr. STUCKEY. Will the gentleman yield for a question?

Mr. KEITH. Certainly.

Mr. STUCKEY. I would like to ask this, before our time runs out, and I know we are pushed. Thank you, Mr. Keith.

The SEC has stated that the charges are too high. Now if your charges are too high, as they have stated, then what I would like for you to do, and with the consent of the committee you can have this submitted to us, and that is compare the charges with other industries, and I tried to bring this out with the banking industry and with other related industries earlier, and it seems that we are not getting anywhere with it.

I would like for a comparison to be drawn, if it could be, between the charges that are made by the mutual funds compared with other related industries, and by that I mean banks, private investment counsel, savings accounts, a person going to an individual broker, and if it would be possible, could we have a comparison of various savings and investment methods to be drawn over a 10-year period of time. Take from now and go back 10 years.

I believe that the average investment in a mutual fund is \$4,500 in round figures. Let's take say \$4,500, 10 years ago originally kept in cash, its total value today, and its purchasing power expressed in dol-

lars today, and let's do that with say a savings account. Say take 5 percent. Let's do it with banks. Let's do it with private investment capital, and let's do it with a person on his own investing this money in the market himself. I think this will give us a comparison as to whether the 5-percent charge is too high or whether it is reasonable.

As I say, take the original investment, then the total amount, the dollar value in 10 years, and also the purchasing power expressed in dollars. I would like to see that comparison if it is possible that this be furnished.

Mr. KOSTMAYER. We will be delighted to furnish that Mr. Stuckey. We may have some problem with the private investment counsel but the other aspects of it I think we can get to it immediately.

Mr. STUCKEY. The reason I am asking for this is because the SEC, their whole basis for the 5 percent that I have been able to see is that they say compared with related industries.

Mr. KOSTMAYER. Right, sir.

Mr. STUCKEY. And with related businesses your 5 percent is too high.

Mr. KOSTMAYER. We will do this.

Mr. STUCKEY. And any other businesses that you would like to have in here, insurance companies or otherwise, I would like to see this, because I think this would give us—and I hate to use these words—but I think it would give us a guideline to sort of look at and compare to see if the 5 percent is in line.

Mr. KOSTMAYER. We will do that.

Mr. Moss. Without objection the record will be held at this point to receive the information.

(The following letter was received by the committee:)

ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC.,
New York, October 30, 1967.

HON. WILLIAM STUCKEY,
House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE STUCKEY: During the hearings held on October 16, 1967 before the Subcommittee on Commerce and Finance with respect to H.R. 9510 and H.R. 9511, you asked me whether a comparison could be made of various investment and savings media by looking at the value now of a given amount of money which during the past ten years was: (1) kept in cash; (2) deposited in a saving bank account at 5% interest; (3) invested by private investment counsel; (4) invested by the individual investor; and (5) invested in mutual fund shares (pp. 455-56 of the Transcript). You suggested that \$4,500 be used as the starting amount.

In response to your question, I enclose a chart entitled "Comparison of Various Savings & Investment Media, 10 Years 1957-1966," which was filed as Exhibit 2 to the Statement of the Investment Company Institute before the Subcommittee in connection with the pending legislation. This chart not only furnishes the information called for by items (1), (2) and (5) above, but also shows the results after the past ten year period, of a purchase at the beginning of the period of Series "E" Government Bonds.

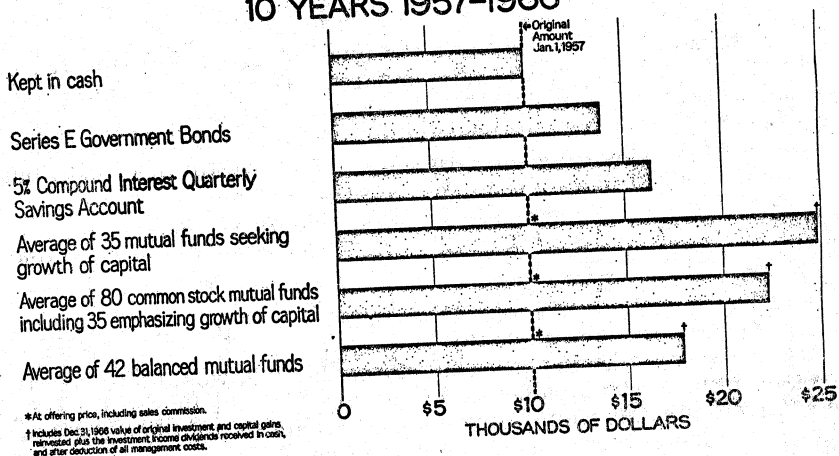
Although \$10,000, rather than \$4,500, is used as the initial amount in the chart, I think it is appropriate as the basis for the comparison which you desired. Unfortunately, we have been unable to find any published statistics or indices which provide any basis for showing how an investor would have fared had he entrusted his money with private investment counsel or invested it by himself as referred to in items (3) and (4) above. To this extent, I regret that I am unable to answer your question.

If you should have any further questions, please let me know.

Very truly yours,

JOHN H. KOSTMAYER.

COMPARISON OF VARIOUS SAVINGS & INVESTMENT METHODS 10 YEARS 1957-1966



Mr. KEITH. Mr. Day, I would like to know how you can be a member of the board of directors of several insurance companies without a little bit of conflict of interest if these are really competing companies.

Mr. DAY. How do you mean, Mr. Keith?

Mr. KEITH. I note on page 2 of your statement, where you listed your qualifications:

I have written a number of published articles on life insurance subjects and am a member of the board of directors of several insurance companies.

Mr. DAY. I see what you mean. Six of those are all in the Zurich group of insurance companies which are all one fleet, as you know.

Mr. KEITH. I am sorry to have exposed the relationship there. Isn't that a little misrepresentation. Aren't these all pups of the same parent?

Mr. DAY. Well, I am on the boards of two other companies.

Mr. KEITH. What are the other two?

Mr. DAY. They are not in any conflict with the Zurich operations.

Mr. KEITH. What are the other two?

Mr. DAY. One of them is the People's Life Insurance Co., which is the largest home office company here in the District of Columbia. The other one is a reinsurance company.

Mr. KEITH. I will agree that there is no conflict there. Thank you. If you had an internally managed company, you could use, I suspect, the resources of that company to recruit, train, and pay salesmen over this lean period, is that correct?

Mr. DAY. Well, you could, but the money has to come from someplace. It has got to come from money that is received in from the people who are buying the product, whatever type of—

Mr. KEITH. It could come out of the management company. They are the ones that are really standing to gain by the increase in portfolio.

Mr. DAY. Well, that is true, but I assume you don't suggest that they just make a contribution which they never expect to get back.

Mr. KEITH. No; but I suggest that—

Mr. DAY. It is similar to—

Mr. KEITH. Similar to the ideas that have been adopted by many of the high-grade insurance companies, they pay salaries to the starting agent.

Mr. DAY. They do indeed and I want to comment on that.

Mr. KEITH. Recently they have gotten into a lot of career underwriting.

Mr. DAY. Yes; I wanted to comment on that statement of the chairman's, because it is the usual pattern to have financing plans for new agents, and to subsidize them and assist them during their training and orientation period, and the period when they are trying to get started.

But just as that is done in a life insurance company, the only place that money can come from is either out of the investment income or out of the money that has been paid in by some other policyholders. There is no brooding omnipresence of money up there that is not going to cost anybody anything.

Mr. KEITH. That I imagine is quite well kept track of by the insurance commissioner of the State involved, and that he has certain regulations with reference to the success or failure of these agents and they had better get out of the business of they don't produce. You have got to make the plan work. But even as it is good business for an insurance company to take it out of the investment income, it all comes out of the policyholder's pocketbook.

Mr. DAY. Well, the investment income is not used for that purpose in a life insurance company. I said these are the only two sources of money they have, but they do not use investment income for sales expense. That is used to support the reserves.

Mr. KEITH. It comes out of the policyholder's pocketbook in the average mutual company, and the expenses come out of the policyholder's pocketbook. In the case of a mutual company it is one and the same thing.

Mr. DAY. That is correct. It comes from the amount that is paid in by policyholders—to a large extent by the policyholder buying that particular policy as to which the sale is made—but it is also subsidized over a period of years, and, in effect, loaned to the sales expense of that particular policy, by taking it out of funds that have been received on policies previously sold.

Mr. KEITH. The point I am trying to make here is, that if you have an internally managed company, where it is good for the management company, to get increased increments of capital so that they are in a position to pay out when shareholders want their money, they have got to have money coming in. It is good company business to hire and train and pay for qualified people to come into the business to keep capital coming into the fund.

Mr. DAY. Well, I don't believe the commission would work that way, Mr. Keith, because while there is discussion here and in this proposal about the management fees, the fact of the matter is there isn't enough made or potential for profit out of simply managing the fund to be

able to use the profits on running the fund to pay for a sales force to go out and bring more money in to be managed.

Mr. KEITH. In an internally managed company, that is what you have.

Mr. DAY. Well, they couldn't pay commissions and pay these loadings to salesmen to keep the salesmen actually going around calling on the customers. There wouldn't be enough money for it in there.

Mr. KEITH. If you have got a billion dollar fund, and you get investment income on it, the expense for advising Massachusetts Investors Trust, is 0.18.

Mr. KOSTMAYER. It is in that range, I know.

Mr. KEITH. And you take that figure and contrast it with, we will say, 0.50, what could you have for a sales force?

Mr. KOSTMAYER. Mr. Keith, may I make one point in this connection?

Mr. KEITH. Yes.

Mr. KOSTMAYER. There is no necessary connection between a contractual plan company and a fund under management. Not all contractual plan companies are adjunct of mutual fund operations, and it is particularly true that new companies coming into this business frequently enter as sales organizations and contractual plan companies only, and have no other resources on which to call.

Mr. KEITH. Yes, I can see that; but it is one big ball of wax, nonetheless. We don't find at this table salesmen. We find at this table people speaking for the investment companies, really, and it might be interesting, Mr. Chairman, to have a salesman appear here. These gentlemen are speaking for the salesmen, but they are also speaking for the management companies as well.

Mr. KOSTMAYER. In the case of my own company, Mr. Keith, I suppose that 80 or 85 percent of our revenues are derived from sales commissions on the contractual plans and mutual fund shares, so that when we talk about changing the front-end load, we are talking about changing practically all of our income.

Mr. MOSS. Would you yield at that point?

Mr. KEITH. Certainly.

Mr. MOSS. How many of your member groups are exclusively sales organizations?

Mr. KOSTMAYER. I do not know, Mr. Chairman. We can find out for you.

Mr. MOSS. I think it would be very interesting.

Mr. KOSTMAYER. Certainly of the smaller ones, I think a high percentage would be.

Mr. MOSS. Well, that is one of the facts I think we would be interested in, how many of the large ones are exclusively sales.

Mr. KOSTMAYER. We will certainly find out and report to you.
(The following letter was received by the committee:)

ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC.,
New York, N.Y., November 6, 1967.

HON. JOHN E. MOSS,
House of Representatives,
Washington, D.C.

DEAR MR. MOSS: During the testimony presented by the Association of Mutual Fund Plan Sponsors, Inc., at the hearings held on October 16, 1967, before your sub-committee on Commerce and Finance with respect to H.R. 9510 and H.R.

9511, you asked me for information concerning the number of plan sponsors which are "exclusively sales organizations" (transcript P. 463). I told you I would find the answer and report it to you.

I have checked the information available to me with respect to the more than forty (40) companies which offer contractual plans. I find that three of those companies are exclusively sales companies, and do not either directly or indirectly act as the investment advisor for any mutual fund whose shares are used as the underlying investment in the contractual plan. In addition, however, at least two large plan sponsors, First Investors Corporation and Investors Planning Corporation of America, derive a very significant part of their revenues from selling shares of mutual funds for which they are not investment advisors.

I should emphasize that despite the fact that most contractual plan sponsors are not exclusively sales organizations, the SEC's proposal to abolish the front-end load would destroy the contractual plan business as a whole and would have a most severe impact on almost all mutual fund organizations which include the sale of contractual plans. Abolition of the front-end load would also deny to investors a valuable means for the periodic accumulation of mutual fund shares.

Some of the largest companies which sponsor contractual plans, including a significant number of publicly owned companies, derive very substantial revenues from this source, and elimination of the front-end load would seriously affect their financial positions, even though they might continue to derive revenues from other sources. In fact, some mutual fund sales organizations effect most of their sales in the form of contractual plans, and the elimination of contractual plans would in all likelihood result in such a limitation on the inflow of new capital to the related mutual funds as to cause a substantial excess of redemptions over inflow of new capital.

In the case of smaller mutual funds, the elimination of the contractual plan could well mean the entire destruction of the mutual fund complex. For instance, there are twenty-one contractual plan sponsors whose contractual plans relate to mutual funds with assets of \$50,000,000.00 or less. It is well known that it is very difficult for investment advisors to receive substantial revenues from the management of mutual funds of that size. For instance, assuming an annual advisory fee of one-half of one percent, a fund of \$10,000,000.00 of net assets would have a management fee of \$50,000.00 a year, and a fund of \$40,000,000.00 would have a management fee of \$200,000.00 a year. From those fees, the investment advisor has to pay all its own expenses and many expenses of the mutual fund as well. The revenues derived from the sales of contractual plans and the new cash inflow to the mutual funds from this source are essential to the existence of these mutual fund organizations.

In addition, new groups organizing mutual funds very often couple these with contractual plans and depend upon contractual plans as an essential source of revenues to assist them in establishing their programs. The elimination of the contractual plan would mean that many of these mutual funds would never be organized and the benefits of a wider variety of mutual funds to choose from would not be made available to potential investors.

Finally, and most important, elimination of the front-end load would deny to a vast group of potential investors the opportunity to invest in mutual funds or to invest in any equity vehicle at all. It is only because of the incentives offered by the front-end load that mutual fund salesmen have been able to bring the benefits of mutual fund investing to many persons of moderate means who would not otherwise have learned about this vehicle.

Let me take this opportunity again to express my appreciation to you and your colleagues for permitting our association to testify before your subcommittee. If you should have any further questions or should you desire any further information, please do not hesitate to let me know.

Sincerely,

JOHN H. KOSTMAYER.

Mr. KEITH. Well, we get back to the question that I have raised throughout these hearings, as to which came first here, the investment company or the sales organization.

I noted that in one bit of testimony it was said—I think it was Mr. Cohen's though it may not have been—that the investment company sought out sales forces to sell shares so that there could be more assets

with which the investment company could operate and receive their compensation; and then he went on to say, that the mutual funds contract with the management company for their services, but actually it can be said that it is the management companies initiate the contracts with the mutual funds in the initial phase of the operation.

And so what we, as a committee, are concerned with is one ball of wax, and that is the way the Commission's recommendations came in. It is a hard point to make, as individual witnesses testified from their particular points of view, but we see it as a whole.

It does not mean just because I am turning the pages of your testimony so quickly that I have necessarily bought all you have had to say.

A small point. On page 14:

First, annual premium deferred annuities now sold by life insurance companies are sold with a front-end load of as much as 50 percent.

Generally speaking, those front-end loads on annuity policies which are those without any life insurance benefits are less than 50 percent, I believe.

Mr. DAY. Some companies use 50. There is a great range, it is true.

Mr. KEITH. Generally speaking, they are less than 50 percent, I believe, because there is no life insurance element.

Mr. DAY. Are you referring, Mr. Keith, to the front-end load or to the commission to the agent? The commission to the agent even in a contractual plan is only 25 percent.

Mr. KEITH. This was life insurance.

Mr. DAY. Yes; I know.

Mr. KEITH. To which you are referring here, and in the annuity policies, generally speaking, you have some cash values in the early years of the contract?

Mr. DAY. Oh, yes.

Mr. KEITH. And in the first year as well?

Mr. DAY. Yes, at least 50 percent. But the 50 percent that I am referring to as the front-end load, only part of which would be, in the annuity plan, the actual commission of the agent. The commission of the agent in an individual annuity plan would typically, in fact, as far as I know universally, be lower than the commission on an ordinary whole life policy because your total load on an ordinary life policy is 100 percent or more.

Mr. KEITH. I guess I did not read the fine print. If that refers not to the commission but to the total load—

Mr. DAY. Only to the total load; yes, sir.

Mr. KEITH. You have to watch these insurance men.

Now then, you conclude, "I cannot buy that. Even the Washington Post cannot buy it."

Has the Washington Post taken a stand on this particular matter—

Mr. DAY. Yes; they had an editorial some months ago that said, in effect, that when people are told very clearly what is being taken out for sales expense, that that is all that is necessary.

Mr. KEITH. Well, the administration of which you used to be a part apparently in one area differs with the Washington Post.

Mr. DAY. I am sort of an in-law of the present administration.

Mr. KEITH. I have no further questions at this time, Mr. Chairman.

Mr. Moss. Mr. Watkins?

Mr. WATKINS. Thank you, Mr. Chairman.

I differ a little bit with my distinguished chairman. I think, Mr. Day, your testimony has been most enlightening, even though it is a contrast. I think you have given us a very fine view of the insurance business and just what happens there. I just wonder many times, after listening here today and reading some of the other briefs, why I did not go into the insurance business instead of the motorized business that I am in, instead of being in a grease pit. But I think your testimony has been most helpful to me.

I certainly feel as though, without an opinion at this time as to how I feel about the SEC's decision, I do not know, it is just amazing to me to sit here and listen.

How do you sell your insurance if you do not sell it with salesmen? I am just not junior and I have been buying insurance, a little of it. In fact, in the early days the banks made me buy it so I could protect my loans.

Mr. KEITH. Will the gentleman yield?

Mr. WATKINS. No, you talked long enough.

Mr. KEITH. I want to know if you bought term insurance or if you bought permanent insurance.

Mr. WATKINS. Straight life. It was cheaper and I could hock it more easily. It was mostly in hock. But we must have salesmen, I do not think there is any question about it.

The big question here is that the SEC feels as though it should be paid differently and they want to rule the business out, and I have heard you make a remark and I would like to question Mr. Kostmayer on that.

You would be out of business. What do you mean you would be out of business if you hock this sales plan out?

Mr. KOSTMAYER. Well, sir, I am now talking specifically about, of course, the contractual plan business.

Mr. WATKINS. You said the business would be through?

Mr. KOSTMAYER. Yes, sir. The SEC's proposal is that the sales charge, which is allowable over the life of the contractual plan which is now a total of 9 percent, be reduced to 5 percent. That is approximately in half. And that the front-end load be eliminated.

Now what this means, Mr. Watkins, is simply this: That instead of being allowed to take 50 percent of each payment in the first year, we would be allowed to take 5 percent of each payment. In other words, the SEC has proposed that our first-year revenues be reduced to 10 percent of what they presently are, assuming that the payments would be persistent, which we think they would not.

Mr. WATKINS. Let me ask you one other question. I will address this to Mr. Kostmayer.

What does the average salesman make in this business?

Mr. KOSTMAYER. Well, sir, I would say that the average salesman—

Mr. WATKINS. Per year. I do not mean per week or month. What does he make in a year?

Mr. KOSTMAYER. Oh, maybe \$1,000, \$1,500, because we have many part-time salesmen. I would say that the average full-time salesman probably makes—

Mr. WATKINS. What does a full-time salesman make?

Mr. KOSTMAYER. Oh, maybe \$7,000 a year, \$7,500 a year.

Mr. WATKINS. How do you get men at that price?

Mr. KOSTMAYER. It is difficult.

Mr. WATKINS. And part-time, they get about \$1,500?

Mr. KOSTMAYER. At the most, on the average.

Mr. WATKINS. That is on this basis here?

Mr. KOSTMAYER. Yes, sir.

Mr. WATKINS. That you are paying them now. What would they get if the SEC plan went in? How much would they make? You say you could not get them. I imagine if they are getting \$7,500 and \$1,500, you could not hire a man, could you?

Mr. KOSTMAYER. We could not hire a man and we could not retain our present career men, the men who make a living in the business, who stay with it.

Mr. WATKINS. That is the \$7,000 a year man?

Mr. KOSTMAYER. That is right. He could not possibly stay in the business.

Now it is conceivable that those who come and go in the night and to whom the income is less important might be able to remain in the business, but it would certainly destroy the core, the hard core of the retail sales organizations in this line of endeavor.

Mr. WATKINS. I think that is important, Mr. Chairman.

Mr. MOSS. So does the chairman.

Mr. WATKINS. I think it is important testimony.

Mr. MOSS. And if the gentleman would yield?

Mr. WATKINS. I yield.

Mr. MOSS. The chairman would point out that in the State of California, approximately 10 percent of the population of this Nation, without a front-end load, that it accounts for in excess of 20 percent of the sales of mutual funds, and I think most of these gentlemen have some affiliations that operate quite profitably in California.

Am I correct?

Mr. ROACH. Our sales organization does very well.

Mr. MOSS. Very well?

Mr. ROACH. They are very happy with California.

Mr. MOSS. That is correct, and so this is another example of the fact that you can do all sorts of things with statistics, and you can have some very interesting exercises, but to forecast that you are going out of business merely means that you would change the format of operation, not that you go out of business.

I have a great confidence in the ability of business to survive and to adapt, and I have been, in 20 years as a legislator, the recipient of advice on so many occasions that I can no longer count them, that if I cast my vote in a certain way I would be putting someone out of business, and looking back in retrospect, I do not know of a one that has gone out of business because of those votes.

Mr. KOSTMAYER. Mr. Chairman, let me restate my—pardon me, sir.

Mr. WATKINS. Go ahead.

Mr. KOSTMAYER. I wanted to restate my reply.

Mr. WATKINS. We are going to have a quorum call in a minute and we are all going to have to go.

Mr. KOSTMAYER. I did not mean to reply that the companies which are in this business will, as businesses, go out of business. I meant to say that the contractual plan portion of it would be destroyed.

I agree with you, Mr. Chairman, that these companies might use their organizations for other purposes, to sell life insurance, for example, to sell mutual fund shares, and this kind of thing.

Mr. MOSS. Well, the fund salesmen in my State have to be selling funds.

Mr. KOSTMAYER. I said fund shares and life insurance.

Mr. MOSS. That is what I say. And I think that a meaningful comparison might be to take the number of persons engaged in selling of funds in California and compare their overall average income with a like block in a State that has, we will say, a somewhat comparable, if you can find it, and I do not think you can, volume of sales of fund shares. In view of the fact that we are highest of all in the Nation, why that comparison would be difficult, so we would have to take the one with the second highest volume and see what the average of the sales force, the income there is.

That would be a meaningful, relevant statistic.

Mr. WATKINS. Mr. Chairman, would you yield just a second?

Mr. MOSS. I will yield back to you.

Mr. WATKINS. I am going to check on Pennsylvania.

Mr. MOSS. I think it would be very helpful.

Mr. KEITH. Will you yield just a minute?

Mr. WATKINS. Yes, go ahead. Go right along. I am with you.

Mr. KEITH. I have been here right along.

Mr. WATKINS. I know you have. I thought perhaps you would send me a sick card. I was out for about a week or 10 days and was very sick and you did not send me a card and I am hurt by it. And the chairman too.

(Off the record.)

Mr. KEITH. Is it not true that the average salesman in these plans is not a full time aggressive career salesman? The average salesman is a man who sells stocks and bonds and mutual funds other than contractual plans and for him to call on the weekly wage earner, as contrasted with the man who can buy 100 shares of this, that, or the other thing, he has to have something that the wage earner can buy.

Mr. KOSTMAYER. I think this is correct, Mr. Keith. The typical mutual fund salesman is selling other things. We may be selling face amount certificates, life insurance, over-the-counter securities, listed securities, and contractual plans, and I think the real question is whether the elimination of the contractual plan would deprive a particular market of a valuable service, and not whether or not it would reduce the salesman's income.

Mr. KEITH. It would reduce his income somewhat?

Mr. KOSTMAYER. Certainly.

Mr. KEITH. But it would more, as you say, deny the schoolteacher, the fellow—well, for example, we had a guest in here, a constituent of mine, whose husband runs a gas station.

Mr. WATKINS. Sells insurance?

Mr. KEITH. No; but she bought a mutual fund, and would not ordinarily have been called on by somebody selling stocks and bonds where, in order to make a dollar for the time spent, they would have to sell a lot of stocks and bonds. So you are serving in addition to those who can buy large amounts the retired person or the person who teaches school.

In my hometown one of the schoolteachers sells mutual funds, and makes \$1,500 to \$2,000 a year. She is known in the community. She is bright. And it supplements her income. So it would no longer be worth her while, with the contacts that she has, if she was going to get only 5 percent.

Mr. KOSTMAYER. Yes, that certainly is true.

Mr. KEITH. Thank you.

Mr. WATKINS. You are welcome.

Mr. Kostmayer, you said here 30 days in answering a question. I understood you to say that you would even go so far as 60 days you would give all the money back.

Mr. KOSTMAYER. Yes, sir; that is under a slightly different set of circumstances.

The 30-day right of refund is unconditional. It is simply an offer to the new purchaser. If that new purchaser is late in making his second payment, we feel that since he has embarked upon a program of 120 months that clearly this is the wrong vehicle for him. We ask him to get out and accept a refund in full.

Mr. WATKINS. Now just one other thing.

Contracts, in talking about insurance and you can answer this very probably, I do not think anybody understands an insurance contract. I consider myself normally intelligent. When you get through reading the fine print and everything that is written I wish the SEC would try to say something about that. Let them put in less words. I am confused and I think everybody in America is if he tries to read his own insurance policy.

Mr. KEITH. Trust your agent.

Mr. WATKINS. There is the question whether insurance salesmen are honest. I think all salesmen are honest until one goes crooked. My boys sometimes spread it on a little bit in the trucking business in truck sales and all, but any good firm always changes it when they come back.

I want to say in conclusion, because we do have to go I think, Mr. Chairman.

Mr. Moss. That is correct.

Mr. WATKINS. I want to thank Mr. Roach and Mr. Kostmayer and Mr. Day and you gentlemen for being here. Your testimony is most helpful and I am going to study it. My mind is not made up as to how I will vote or what will happen.

Mr. Moss is a great friend of mine, very persuasive, and so is my friend on the right here too. I do not know what I will do, but I appreciate your testimony. Thank you for coming in.

Mr. Chairman, may I be excused?

Mr. Moss. Yes, you may.

And I want to thank you gentlemen also.

(The following letter was received by the committee:)

ASSOCIATION OF MUTUAL FUND PLAN SPONSORS, INC.,
New York, N.Y., November 7, 1967.

Hon. HASTINGS KEITH,
House of Representatives,
Washington, D.C.

DEAR MR. KEITH: I am pleased to reply on behalf of the Association of Mutual Fund Plan Sponsors, to questions numbers 8-10 contained in your letter of October 27, 1967. The following are our answers:

Q-8. A specific objection to the front end-load is that people have been forced to redeem in the early years of their plan at a loss to pay unavoidable hardship expenses arising from illness, unemployment, or death. What percentage of planholders have been forced to liquidate for hardship reasons? How many of these have liquidated at a loss? What is the aggregate loss sustained by such persons in a typical twelve month period?

A-8. Benson & Benson, Inc., of Princeton, New Jersey, have conducted a survey, referred to in my testimony before the Sub-committee, which contains some information that is informative in connection with your question. Professor Herbert Arkin, Chairman of the Statistical Department of the Bernard W. Baruch School of Business and Public Administration, established the criteria for this survey before it was undertaken and analyzed it for us afterwards. The report was designed to determine what proportion of planholders who terminated at a loss in the early years of the plan did so for reasons of hardship.

The result of the Benson & Benson survey and analysis show that only some 45% of planholders who liquidated at a loss can properly be included among those who were forced to liquidate for hardship reasons. In the test period which Professor Arkin used these amounted to only 4½% to 5% of all contractual planholders who initiated their plans within that period. We have applied Professor Arkin's figures to a broad group of some 17,000 accounts started by four different sponsors in 1951 through 1953, and our study shows that of the approximately 18% of those accounts which had terminated with losses as of December 31, 1966, only some 8% constituted persons who were forced to liquidate for hardship reasons.

In the period for which these 17,000 accounts were considered, the aggregate loss sustained by all persons who terminated with losses was \$240,000. Applying Professor Arkin's factor of 45%, this would mean aggregate losses of \$108,000 in that entire period for those planholders who were forced to liquidate, or an average of \$79.00 for each such account which was terminated with a loss. The figures set forth above relate to planholders who were forced to liquidate for hardship reasons and who suffered a loss. We do not have any comparable statistics with respect to planholders who may have been forced to terminate their plans due to financial hardship and who have nonetheless profited from their plans. As I mentioned in my testimony, there is available to all planholders the right to withdraw up to 90% of the current liquidation value of the mutual fund shares held under their plans and subsequently to reinvest an equivalent amount without paying any sales charge at all. As a result, if a person suffered a financial hardship and had profited from his contractual plan investment, he could take full advantage of the 90% withdrawal right and have at least as much money available to meet that financial emergency as he had originally invested, and perhaps significantly more. To the extent that contractual planholders with profits terminate their plans due to financial hardship rather than taking advantage of the withdrawal privilege, this may reflect a choice on the part of those planholders to terminate their investment programs for some other unrelated purpose, although we have no statistics in this regard.

You asked us to furnish you the aggregate losses sustained by persons who terminated due to hardship in a typical 12-month period. We have examined the records of one leading contractual plan sponsor which issued 13,265 plans in 1965. By December 31, 1966, 281 such plans had terminated with losses of \$62,200.00. Applying Professor Arkin's factor of 45%, this would mean that 126 plans were liquidated due to hardship reasons, with aggregate losses of \$28,000.00 which represents under 1% of the plans considered.

Q-9. How can prospective purchasers of mutual fund plans be made effectively aware of the existence of level load voluntary plans so that they can compare the relative merits of contractual and voluntary plans?

A-9. The prospectuses used by all contractual plan sponsors of which we are aware include at some point, either in the body of the prospectus of the sponsor or in the prospectus of the investment company whose shares underly the contractual plan and which usually accompanies the sponsor's prospectus, a description of the voluntary plan offered with respect to the shares of that mutual fund. For instance, I enclose a prospectus of my company, First Investors Corporation, with respect to the shares of Fundamental Investors. You will note that

on page 1 of the First Investors prospectus there is a reference to, and on page 3 of the Fundamental Investors prospectus there is a detailed description of, the systematic share accumulation account, which is the voluntary plan offered by Fundamental Investors.

This practice of furnishing to contractual planholders in the prospectus which must be delivered to them a description of the voluntary plan with respect to the shares of the same mutual fund goes far beyond practices of which we are aware in other businesses. For instance, as former Postmaster General Day testified before this Subcommittee, 3 states have savings bank life insurance which is offered without the use of agents and relates sales charges.

No one requires that the agents offering regular life insurance policies with the full front-end load include in the literature delivered to the prospective purchasers any reference at all to the availability of savings bank life insurance in those three states, or any reference to the availability of term life insurance as an alternative to the whole life insurance product which is being sold.

Q-10. What is the median loss sustained by contractual planholders who liquidate at a loss? What would the median experience of this group have been if they had invested in voluntary plans?

A-10. We have examined the records of the 17,000 accounts opened by 4 sponsors in 1951 and 1953 which are referred to above and we find that the median loss sustained by holders of those accounts who liquidated at a loss in the period from December 31, 1966 was \$114.00.

You asked if we could inform you of the median experience of such a group of contractual planholders if they had invested in voluntary plans. Unfortunately, I find it impossible to furnish an answer which would be informative. As I indicated before the Subcommittee, we believe that voluntary plans are not truly comparable to contractual plans. They are quite different vehicles. Most important in this regard is the fact that holders of voluntary plans, without the incentive created by the front-end load, have much poorer records of persistency than do holders of contractual plans. Our studies indicate, for instance, that some contractual planholders in some periods have been 10 times as regular in making payments as have voluntary planholders with respect to the shares of the same mutual fund. As a result, if the people who had purchased the 17,000 contractual plan accounts to which I have referred had instead commenced to voluntary plan programs, it is almost certain that they would have made far fewer payments on those programs than they had made on the contractual plan programs. It is therefore impossible to prepare any kind of meaningful statistics.

My associates and I very much appreciated the opportunity to appear before the Subcommittee of which you are a member. Please tell us if there is any further information which we may be able to furnish to you in connection with the hearings.

Sincerely,

JOHN H. KOSTMAYER.

Mr. Moss. The committee will now stand adjourned. We will have no further questions for you. The committee will adjourn now to meet again at 3:00 this afternoon in the same room, at which time Mr. Robert M. Loeffler, vice president, Investors Diversified Services, will be our first witness.

The committee is now adjourned.
(Whereupon, at 12:30 p.m., the committee adjourned, to reconvene at 3 p.m., the same day.)

AFTERNOON SESSION

Mr. STUCKEY. The committee will come to order.

This afternoon we will hear the witness and a statement of Mr. Robert M. Loeffler on behalf of the Investors Diversified Services, Inc.

If you would like, you can summarize your statement and have it entered into the record if there is no objection.

STATEMENT OF ROBERT M. LOEFFLER, DIRECTOR AND VICE PRESIDENT—LAW, INVESTORS DIVERSIFIED SERVICES, INC., ACCOMPANIED BY JOSEPH F. GRINNELL, GENERAL COUNSEL

Mr. LOEFFLER. Thank you, sir.

(Mr. Loeffler's prepared statement follows:)

STATEMENT OF ROBERT M. LOEFFLER, DIRECTOR AND VICE PRESIDENT—LAW,
INVESTORS DIVERSIFIED SERVICES, INC.

Mr. Chairman and members of the committee, my name is Robert M. Loeffler. I am Vice-President—Law and a director of Investors Diversified Services, Inc. ("IDS") of Minneapolis, Minnesota. I appreciate the opportunity to appear before you today to present the views of IDS with respect to certain of the provisions of H.R. 9510 and H.R. 9511.

IDS created four mutual funds for which it acts as investment manager and exclusive distributor. Collectively the assets of these funds amount to approximately \$6 billion. This aggregation of assets is the largest in the field and constitutes approximately 15% of the total assets of the mutual fund industry.

The shares of these funds are sold exclusively by the IDS sales force of approximately 4,000 men and women working full time as sales representatives of IDS. Our sales currently average approximately 15% of the total sales of mutual fund shares. IDS today has approximately one million mutual fund customer accounts and distributes fund shares in all 50 states.

THE MUTUAL FUND AS AN INVESTMENT SERVICE

The creation of funds by management companies is the tradition of the industry, a fact which should be borne in mind. Funds are created by investment management organizations as a means of making their services more widely available and with the expectation of making a profit. Were it otherwise, the mutual fund industry as we know it today would not exist. Rarely, if ever, do mutual funds just spring into being and then go searching for an investment manager and distributor.

Essentially a mutual fund is a means by which an investment management organization offers to the public an investment service—a managed, diversified account with many other services included. This service is specifically designed to reach and accommodate a market composed of customers who have relatively small amounts of money to invest.

Without the small customer, this industry would be dead. Without this market without substantially greater risk and cost.

Currently, the median amount that a new IDS customer invests is \$1,280. These investments are then pooled, and each customer shares pro rata the dividends, the gains and the losses and pays his pro rata share of the cost of the service. Mutual funds are designed to permit new customers to enter without affecting the value of the investment of existing customers. Existing customers may withdraw their full pro rata share without affecting the investment of others—the redemption feature unique to the open-end fund.

A mutual fund typically is a corporation separate in legal existence from its sponsor. There is nothing in the law that requires this. The origin of the separately incorporated fund predates the Investment Company Act of 1940. The purpose was to insulate the assets of the customers from any legal liabilities of the sponsor.

When the Investment Company Act was enacted, it provided in effect that:

if a fund was not separately incorporated it must, nevertheless, have a committee or some other equivalent of a board of directors;

at least 40% of the directors or committee members (other than for a no-load fund) must be unaffiliated with the fund manager; and

there must be a written contract between the fund and the manager which must be approved at least annually by either the participants in the fund or by a majority of the unaffiliated directors; any change must be approved by the participants.

Today, with rare exception, a majority or more of the directors are unaffiliated with the fund sponsor. Their function is to oversee the operations of the manager and to make certain that it is fulfilling its obligations and commitments to its

customers, the fund shareholders. At IDS, 10 of the 12 directors of each of the four funds are unaffiliated with IDS.

This system has now been attacked as inadequate to protect the customer from overcharging by the fund's creator and manager. I think this attack is ill-founded. The fact is that there is no other industry in the United States, at least insofar as I have been able to discover, whose customers have the unique protection that the customers of this industry have.

Here the customers have disclosed to them in writing the precise cost of the service before purchasing it, and all material facts relating to it. The customers of few industries have even that today. Then, in addition, by law, they have the additional protection of an independent committee in the form of the unaffiliated directors, with the power and duty to oversee the operation, and to represent them with respect to any future changes in the charge for the service.

So far as I am aware, since 1940 no management fee has ever been raised. On the other hand, there have been substantial and significant reductions.

CREATION OF THE IDS MANAGEMENT FUNDS

Probably no two funds complexes conduct their operations in exactly the same manner. I think it would be helpful to describe how the IDS group of funds operates within the present legal framework and economic environment.

IDS was incorporated in 1894 in Minnesota. Until 1940 it was engaged solely in issuing and distributing installment savings contracts, known as face amount certificates, with a guaranteed fixed return at maturity. They were sold directly by sales representatives of IDS. The IDS investment department was responsible for the investment of the certificate reserves.

In 1940, after the passage of the Investment Company Act, IDS organized its first mutual fund, Investors Mutual, to be distributed exclusively by the IDS sales force directly to individual investors. Investors Mutual is a balanced fund: 35 to 40% of its assets are invested in fixed income securities, bonds or preferred stocks, the balance in common stocks, generally of a strongly blue chip character. Income has been one of the prime objectives of the fund. Today Investors Mutual has 440,000 accounts and \$3 billion in assets. It is the largest mutual fund in the world.

In 1945 IDS formed Investors Stock Fund, a common stock fund emphasizing income as well as growth. Today Stock Fund has 370,000 accounts and \$2 billion in assets. It is the fourth largest mutual fund in the United States.

At the same time that Investors Stock Fund was formed, IDS formed Investors Selective Fund. It is a small fund and its assets are invested in bonds and preferred stocks. Today it has 6,300 accounts and \$39 million in assets.

In 1957 IDS formed Investors Variable Payment Fund. It is a common stock fund like Investors Stock Fund, but with current income only an incidental objective. Today it has approximately 190,000 accounts and \$830 million in assets.

THE IDS DISTRIBUTION SYSTEM

IDS is itself a broker-dealer registered with the SEC under the Securities Exchange Act of 1934 and with the "blue sky" agencies of the various states. However, the only products sold by IDS sales representatives are the face amount certificates issued by a subsidiary of IDS, the shares of the IDS managed funds and insurance policies issued by another subsidiary. No one other than IDS representatives sells these products. This system in which our own sales force deals directly with our customers is known as direct distribution. We do not distribute to customers through other broker-dealers, a system known as dealer distribution.

Organization of the IDS Sales Force

IDS has a sales force of approximately 4,000 fulltime career representatives; they have no other employment or source of earned income. They are not moonlighters who work at one job during the day and then go out to make occasional securities sales to friends or relatives in the evening.

The IDS sales representatives are carefully selected, trained and supervised by an extensive organization headed by the Vice-President Sales and his staff in Minneapolis, and by nine Regional Vice Presidents, 170 Divisional Sales Managers and 675 District Sales Managers in the field.

Selection and Training of IDS Sales Representatives

The Divisional Sales Managers seek out potential IDS representatives. They interview and test them and check their references and backgrounds. All of this

information, with the results of personality and aptitude tests, is evaluated by IDS against its experience to assess the applicants' qualifications.

There is nothing casual about this process. In 1966, for example, 4,200 applicants sought to become IDS sales representatives, completed the business, personal and family history forms, and took the aptitude tests. Of these 4,200 applicants, only 1,111 were appointed and licensed as IDS sales representatives.

After a new man is selected, and before he is hired and commences dealing with the public, he is extensively trained and thoroughly acquainted with the products offered by IDS, its sales standards and policies. After this training he must pass the federal and state examinations required to secure necessary licenses.

When a new man is finally licensed and sent into the field, his sales manager closely supervises and assists him in getting off to a good start and insures that he adheres to IDS' sales standards. IDS is not interested in keeping marginal salesmen. If a salesman fails to earn \$5,000 in his first year, he is usually asked to consider seeking new employment.

In addition to the training of new men, each sales manager conducts continuing training sessions for his full staff to keep them currently informed of changes in the IDS product line and of proper selling practices.

This training continues throughout the career of each sales representative in this fashion and also at periodic regional and home office meetings and conferences. Recently, 1,250 IDS representatives from throughout the country participated in a three-day working conference at the company's home office in Minneapolis.

Sales Supervision

IDS has developed an extensive supervisory system. Along with their responsibility for training, our divisional and district sales managers have specific, detailed and continuing responsibility for supervising the sales activities of their representatives. Their performance in supervising is measured on a regular basis.

In addition to supervision in the field, a department with more than 40 people at the IDS home office examines all applications submitted by the sales force to make sure there has been no violation of IDS' procedures and sales policies. Each application is referred to an electronic index system to determine what, if any, activity has occurred under that name on that or related accounts within the previous six months. The purpose of this procedure is twofold—to detect any indications of deviation from IDS sales policies and to make sure that the customer is being charged the lowest applicable sales charge to which he is entitled by reason of previous purchases.

IDS has 11 Customer Relations Representatives continuously in the field to audit the operations of the divisional offices and monitor the activities of the sales force through personal interviews of customers selected at random.

Mutual funds do not necessarily fit into the financial planning of all customers at all times. IDS sales representatives also sell life insurance and savings certificates issued by subsidiaries of IDS. The IDS philosophy is that sound financial programs for the customers it serves are based on four cornerstones: (1) money in the bank, (2) insurance, (3) a systematic savings program, and (4) investment in equity securities through mutual funds—in that order.

In addition to sales interviews, the IDS salesman is required to make numerous follow-up and servicing calls to discuss his customer's current plans and objectives and to insure that the customer is satisfied in his dealings with IDS. Our experience is that a diligent sales representative will average two sales interviews and four service and follow-up calls in a day. This means 12 sales interviews in a six-day week. Experience has shown that a successful IDS salesman averages five sales interviews per sale.

The Economics of the IDS Sales Operation

IDS has one million mutual fund accounts. A profile of the average IDS customer is as follows: (1) he is a married man of approximately 50 years of age; (2) he is a high school graduate with some college or other professional training; and (3) he has an income of approximately \$8,000 a year. On the basis of experience, we can expect his account to remain on the books for over 17 years.

The maximum sales charge at IDS is 8% and the minimum is 1% depending on the size of the investment. A customer's existing investments in any of the

funds are aggregated with any new purchase to determine the applicable sales charge.

Furthermore, various options and privileges are available to IDS customers which significantly reduce the effective sales charge as a percentage of the total amount paid in. At IDS, capital gains distributions and investment income dividends may be reinvested without charge. In 1966, at IDS \$238,332,000 was invested in that way. Also a shareholder of one IDS fund may transfer his investment to another IDS fund without sales charge or other fee. \$140,211,000 was so transferred in 1966.

The effect of these various options and privileges is significant. The gross commission income of IDS in 1966 was not 8% of sales, but 6.6%. It was only 4.6% of new money invested, which included reinvested dividends and capital gains. And it was only 3.9% when free intra-fund transfers are included. The trend in all these percentages has been downward.

These are averages not applicable to particular investors. Nevertheless, these options are available to and are availed of by our customers, and with impressive results. For example, if in 1945, when Investors Stock Fund was organized, a customer had invested \$1,000 at an 8% sales charge, his total cost would have been \$80. By reinvesting his dividends and capital gains distributions at no charge, as 95% of Stock Fund investors do, he would have dramatically reduced the effective percentage sales charge on the money he paid in:

At the end of the fifth year he would have paid in a total of \$1,245 and the effective sales charge on the money paid in would have dropped to 6.4%.

At the end of the tenth year he would have paid in \$1,939 and the effective sales charges on the money paid in would have dropped to 4.1%.

At the end of the seventeenth year, the usual life of an IDS mutual fund account, he would have paid in \$3,547, and the effective sales charge on the money paid in would have dropped to only 2.2%.

At the end of the twenty-second year, October 31, 1966, he would have paid in \$5,422 and the effective sales charge on the money paid in would have been less than 1.5%.

In other words, this customer paid a sales charge of \$80 to make an initial investment of \$1,000, and paid nothing to invest an additional \$4,422. If he had then redeemed his shares he would have received \$9,558 with no commission charge, all generated from his original \$1,000, and the effective charge on all money in and out would have been 0.53%. This is a far cry from an 8% sales load.

The results of IDS' fund sales operations are set forth in the following table showing gross sales charges, expenses, and net income or loss for each of the years 1962 through 1966 and for the period ended August 31, 1967.

	1962	1963	1964	1965	1966	8 months Aug. 31, 1967
Sales charges.....	\$23,378,844	\$22,815,100	\$32,243,610	\$40,384,875	\$35,916,149	\$18,064,581
Expenses.....	24,695,836	23,935,204	32,443,694	39,287,374	34,096,444	18,279,895
Net income (loss) before income taxes.....	(1,316,992)	(1,120,104)	(200,083)	1,097,501	1,819,705	(215,314)
Net income as percent of sales.....	(0.38)	(0.32)	(0.04)	0.18	0.34	(0.08)

The following table shows the average gross income of IDS' sales representatives and district sales managers for each of the past five years and as projected for 1967 from the first six months. They have no other source of earnings and must pay their business expenses from the gross set forth below:

AVERAGE GROSS INCOME FROM SALE OF ALL PRODUCTS

	Sales representatives ¹	District sales managers ²
1962.....	\$7,853	\$14,734
1963.....	7,571	13,683
1964.....	8,753	15,687
1965.....	9,159	16,767
1966.....	8,077	14,292
1967 (projected).....	7,233	13,556

¹ Only representatives with more than 18 months of experience are included.

² Divisional sales managers, the next level of sales managers, usually have higher incomes than do district sales managers.

It is apparent from the foregoing that the present level of sales charges is determined by the economics of distribution, and is necessary to maintain an adequately compensated, adequately trained and properly supervised sales force. Moreover, as shown above, when viewed with all of the privileges included, the effective charge to the customer ends up to be low indeed.

Section 12 of the Bills Relating to the Sales Load

Section 12 of the Bills would amend Section 22 of the Investment Company Act to limit the maximum sales charge to 5% of the net amount invested—4.76% of the offering price.

IDS would be happy to see the sales charge on smaller sales lower than 8% if it were economically feasible. We have made studies seeking means by which the maximum sales charge could feasibly be reduced. To date, we have not been able to find a way—and at the same time maintain an adequately compensated, adequately trained, and properly supervised sales force. This does not mean that our efforts in this direction have ceased, but the present level is dictated by economic reality.

What would be the consequences of this proposal? Our studies show that with a 5% maximum the average income of an IDS sales representative in 1966 would have been reduced by \$2,900 to \$5,200, or over 35%. This simply would be inadequate to retain trained sales representatives or permit us to attract and properly train new ones.

I will not urge that the loss of income to sales representatives alone is sufficient reason to reject this particular proposal. There are other social consequences of a serious nature. To begin with, enactment of the proposal would undoubtedly mean that thousands of full time trained securities salesmen specializing in mutual funds will leave the business. Their loss would significantly reduce the availability of this particular investment medium to millions of people. Moreover, most of these persons, those with relatively little to invest, are the very ones for whom mutual funds are probably the most appropriate and safest form of equity investment.

There is another and equally serious consequence which must be mentioned. This proposal would have its heaviest impact on well-trained, full-time career sales representatives like those at IDS. These are the men it would drive from the business, leaving the field to the so-called moonlighter, the part-timer who has another job and sells funds to raise some extra cash. I do not believe this would be either socially desirable or wise. The Securities Exchange Act Amendments of 1964 sought to up-grade the training and qualifications of securities salesmen. This industry and my company joined with the SEC in support of that legislation. The current proposal is utterly contradictory to and inconsistent with those objectives. Therefore, we oppose it.

IDS MANAGEMENT SERVICES

In accordance with the Investment Company Act of 1940, IDS has entered into *Investment Advisory and Services Agreements* with each of its mutual funds. These contracts have been approved by the shareholders and their continuation has been subject to their approval or that of the funds' independent directors.

The name given these contracts is significant. Over and above the furnishing of investment advice, these contracts require IDS to perform—at its own expense—all of the administrative services necessary to the operations of the funds and to assume the expenses of any services performed for the funds by others. Thus, IDS furnishes the funds with office facilities and supplies, and perform or pays for all accounting and auditing services. In addition, IDS is stock transfer and dividend disbursement agent for the funds, prepares the funds' reports and proxy statements, pays for their custodial services and is responsible for the funds' compliance with the record keeping and reporting requirements of state and federal law.

This means that the management fee paid to IDS by each fund is the only expense of that fund.

All of the advisory and administrative services furnished by IDS must meet the approval of the directors of the funds. Each has twelve directors of whom only two are, in any way, associated or affiliated with IDS. The men who serve on these boards are experienced in business, financial and legal affairs. They in-

clude lawyers, college presidents and businessmen. The number of independent directors on the IDS funds boards exceeds the requirements of the Investment Company Act.

The funds have a full-time president, vice-president general-counsel and secretary-treasurer. These officers do not report to IDS and are not affiliated in any way with IDS. They are accountable solely to the boards of the funds. These officers continuously monitor IDS' services. They have access to all records and are provided with periodic and special reports in form and content established by them. Any revision of procedures or standards of business, and any significant changes in existing policies, are discussed with the funds' officers and directors.

The fund directors meet monthly. An executive committee of each board meets weekly. At each meeting of the fund boards IDS makes a formal report. This report includes, among other things, a complete analysis of the stock market and the performance of the funds, as well as a discussion of the economic outlook, the market outlook and the investment strategy to be employed on behalf of each of the funds.

Contract Negotiations

In the past five years four new sets of contracts were entered into with the funds.

In 1966 the contracts were amended to provide for a reduction of the management fees equivalent to the entire net profits attributable to fund securities transactions realized by an IDS subsidiary which had become a member of the Pacific Coast Stock Exchange for this purpose in 1965.

The other three contract revisions were the outgrowth of protracted negotiations. In each instance the funds appointed a negotiating committee composed of independent directors and the funds' General Counsel. For these negotiations IDS furnishes complete financial information concerning IDS' business relationships with the funds. In addition, all available information with respect to other mutual funds and mutual fund managers is obtained and considered.

IDS also formed a negotiating committee to meet with the committee representing the funds. Negotiations of the new contract which went into effect in 1963 extended from April 9, 1962 to November 7, 1962. The negotiations of the 1964 contract changes extended from January 15, 1964 to June 23, 1964. The negotiations of the 1967 contract extended from May 19, 1966 to September 14, 1966.

During the periods of negotiations, these committees met several times each month, sometimes separately and sometimes jointly. During these meetings various offers and counter offers were made and discussed and various alternate arrangements considered. The ultimate agreement as to each contract was the result of genuine arm's length negotiations.

Other Factors Affecting Management Fees

There have been other developments which have contributed to reduction of management fees in the industry generally. As the mutual fund industry—including IDS—grew rapidly after World War II, particularly during the middle and later fifties, management fees grew proportionately. The industry, fund managers as well as fund directors, began to reexamine what until then had been the standard fee of .50% of net assets annually. Some fees were reduced.

By the early 1960's the level of mutual fund management fees was challenged in litigation brought on behalf of the shareholders of various mutual funds. Most of these suits were resolved by reductions in fees, generally by the adoption of sliding scales which provided for lower fee charges as the funds' assets grow.

As the industry grew, there was greater public awareness of mutual funds and the various levels of charges. This awareness increased competition among funds with respect to fee rates, and funds with higher charges met pressure to reduce their expenses to those of their competitors. This pressure was increased by the publicity surrounding the Wharton School Report and the 1963 SEC Special Study of the Securities Markets.

The Results at IDS

For all of these reasons—fund negotiations, increased competition, shareholder litigation, and greater public awareness—management fees generally, and at IDS in particular, have been steadily and substantially reduced in recent years.

The effect on the expense ratios of the IDS managed funds is as follows:

Expense ratio:	Percent
1962	0.53
1963	0.50
1964	0.44
1965	0.40
1966	0.34
8 mos. 1967 (annualized)	0.30

The resultant actual cost to a typical customer with a \$5,000 account in an IDS managed fund is as follows:

Management fee:	
1962	\$26.50
1963	25.00
1964	22.00
1965	20.00
1966	17.00
8 mos. 1967 (annualized)	15.00

The effect has been to reduce the cost per dollar of investment for an IDS customer from 1962 to date by over 43%. These reductions, in total, produced management fees in 1966 which were \$9,300,000 less than they would have been on the basis of IDS' 1962 contracts.

A typical IDS customer with a \$5,000 account, paying an annual management fee of \$15, could not obtain the services provided by IDS—including diversification of risk and professional investment management—outside the mutual fund industry at comparable costs.

Most investment advisers and banks do not accept advisory accounts of less than \$100,000. Those that do set minimum fees which would be prohibitive to the typical mutual fund customer. In Philadelphia, for example, the major bank with the lowest fees would charge at least \$460 per year to handle a \$100,000 account. At IDS the management cost to a fund shareholder with a \$100,000 account is \$300. More to the point, however, is that an IDS customer need not have \$100,000 or \$10,000 or even \$1,000 to invest.

Bank common trust funds are the only investment medium generally offered which are comparable to a mutual fund; however, the management charges imposed for participation in common trust funds are all substantially higher than those charged by IDS. Furthermore, the banks almost without exception impose a minimum annual charge regardless of the amount of money invested. In Philadelphia this ranges from \$75 to \$200, and in Minneapolis from \$125 to \$175. If IDS were to impose a minimum charge of \$75 on each fund account, the cost to our fund shareholders would be prohibitive.

Section 8 of the Bills Relating to Management Fees

Notwithstanding the effectiveness of the present system, Section 8 of the Bills would amend Section 15 of the Investment Company Act to provide that there be a statutory requirement that management fees be "reasonable," and that the courts, in a suit either at the instigation of the SEC or any fund shareholder, be empowered to determine the reasonableness of a fee, in effect to set the fee.

At first blush this proposal may appear innocuous enough. Moreover, it places one who opposes it in the uncomfortable position of appearing to oppose reasonable fees. This proposal is, however, by no means innocuous.

I know of no responsible or competent business man—and the SEC has acknowledged that "on the whole investment companies are managed by competent persons"—who believes his prices for goods or services should be or are unreasonable. This proposal raises a serious question: Who is to have the power to set prices for the products or services, the business man himself or someone else not engaged in the day-to-day running of a business, who does not have the responsibility, who need not answer for the results and consequences of his actions?

This particular proposal constitutes a dramatic innovation in our economic system. I do not suggest that this alone determine in any way the question of whether the proposal is wise or unwise; but I do believe that awareness of that fact is important.

During the history of our jurisprudence courts have always been reluctant to substitute their judgment on business matters for the business judgment of

directors. This proposal would reverse this tradition and direct the courts to substitute their judgment for that of businessmen. Certainly the pricing of a product or service is at the heart of any business operation.

I do not question the competence of a court to determine the reasonableness of a price. Courts, and juries as well, have often been required to do so. They have done so, however, generally in situations where it was necessary to resolve a controversy between private litigants and where the determination would normally affect only the litigants and then only with respect to a particular completed transaction. The practical effect of the proposal in H.R. 9510 and 9511 is to put the courts in the business of regulation; it would impose upon the courts the responsibility and necessity to set prices at which an industry must offer its services in the future. This has never been regarded as the function of our judiciary.

In another respect this proposal is an even more far reaching innovation. This industry is not a public utility. It enjoys no anti-trust exemption permitting a price-fixing agreement among mutual fund managers.

It is a non-protected industry where free entry exists. I know of no statute in the history of the United States absent war time, which gave either a federal agency or a court the power to prescribe the price for a product or service in a competitive industry, and thereby the power to regulate the profits of an industry in accordance with whatever in its judgment it deems to be appropriate or reasonable. This Bill does just that, and I believe it is the first in our history to do so.

Moreover, not only the courts would be engaged in the business of regulating management fees. As a realistic matter this proposal gives to the SEC itself the power virtually to set management fees through threat of litigation and its control over proxy and prospectus requirements.

As I mentioned before, I do not suggest that the fact that this proposal is a significant innovation in our social and economic system determines whether the proposal is wise or unwise. I do submit, however, that there is imposed on the proponent of such legislation the obligation to provide at least some reliable indication of what the probable consequences of the innovation would be. The SEC has not even undertaken to do so. It has given this Committee no evidence whatever of the probable consequences of its proposal either to the industry or to the millions of people whom the industry serves.

If this proposal is enacted, management fees, instead of being governed by the interplay of economic forces and negotiations, as now, would be set by the SEC or a court without the consent of those engaged in the business. Here are some of the questions that arise.

If, as a consequence, management fees were reduced below what competitive forces would otherwise produce, what would be the results? Will the quality of the service suffer? Will the entrance of new companies into the business be inhibited? Will the sponsorship of new funds by those management companies already in the business be deterred? Will newer entrants who have not yet achieved a profitable level of operations be discouraged from continuing? Will the development of new services for fund customers be retarded? Will there be endless litigation or instead will absolute uniformity in both fees and services in the industry result?

Contrast these uncertainties with the known results of the present system. Concentration in the industry is diminishing. The variety and availability of services is increasing. The quality of the service is improving. And the cost of the service to the consumer, the fund shareholder, is decreasing.

We urge you not to replace the dynamic force of a competitive system that is working with a new and untried system having unknown and unforeseeable consequences.

CONTRACTUAL PLANS

The IDS contractual plan—Investors Accumulation Plan—might well have been discussed in my comments on IDS' distribution system because it is a form of distribution. However, in view of the particular concern which the SEC has expressed about contractual plans because of the front-end load feature, this subject is treated here separately.

In September of 1965, after several years of study, IDS introduced a contractual plan for the accumulation of mutual fund shares. We decided to do this because new methods were required to meet the needs of the expanding market

of younger investors. They lack the cash necessary for lump sum investment, but desire to build their resources through the systematic investment of a portion of their monthly income in equity securities.

From our experience we were convinced that a front-end sales charge would be necessary to enable our salesmen to reach customers in this market. The purpose of the front-end sales charge is to provide the initial sales compensation necessary to enable the salesman to work with investors whose monthly investment is so small—the average is only about \$30.00—that the regular sales charges would be inadequate. Before deciding to offer an accumulation plan with a front-end load, IDS weighed all of the competing objectives: the objective of the customer to pay the lowest feasible sales charge and to minimize his potential losses in the event of early termination; the objective of the salesmen to receive adequate compensation; and the objective of the company to make a profit. We concluded that it would be possible to satisfy—at least in part—all of these objectives by modifying the contractual plan then standard in the industry.

Under existing law, contractual plans involving periodic payments can include an initial sales charge of up to 50% of the first 12 monthly payments, and substantially all do.

IDS decided to offer a plan with an initial sales charge, not of 50%, but of 20% with the difference spread over the next three years' payments. Thus the IDS plan has a sales charge of 20% of the first year's payment, 18% of the 2nd and 3rd years' payments, 7% of the 4th year's payment, and 4.2% of the remaining payments. These plans are designed to extend over a 12½ year period and the overall sales charge is 8%.

If an IDS planholder, for any reason, or for no reason, wants to terminate his plan in its first sixty days, or is over a month late in making his second payment, the plan automatically terminates and all of his payments, including the sales charges, are refunded. To insure that these plans are not sold where a regular mutual fund investment would be feasible, IDS will not accept an application involving monthly payments of over \$100.00.

We have had only limited experience with our version of the front-end sales charge. Thus far, however, our confidence in its soundness seems justified. From October 1, 1965 to December 31, 1966, 58,251 accumulation plans were sold. Of these plans, 3,048 or 5.2% were cancelled and the full amount of the customers' payments refunded. Of the remaining 55,203 plans, 1,398 or only 2.5% have been terminated and 53,805 or 97.5% have remained active.

Section 16 of the Bill Relating to Contractual Plans

Section 16 of the Bill would amend Section 27 of the Investment Company Act to prohibit the so-called front-end load on installment payment plans for the accumulation of fund shares.

If this proposal becomes law, it would mean the end for the IDS plan. We have studied the impact of the proposal. We estimate that with our 20% front-end load, and IDS plan must be in force for three years before IDS recovers its costs and begins to make a profit. If the SEC's proposal were in effect, IDS could never make a profit on this operation.

Although IDS experience is limited and the persistency so far has been very good, we are not happy that some loss, however small, has been borne by any of our customers. IDS believes that close supervision of sales practices, strict adherence to its sales policies, and the design of the plan itself have contributed greatly to minimizing losses due to the front-end load.

When IDS began the distribution of its accumulation plan it believed that the potential benefits to the public far outweighed any potential harm. This Committee must weigh the same question. We urge you not to abolish a system of distribution necessary to make the mutual fund form of investment available to a large market for which it is particularly suitable.

IDS PROFITS FROM MUTUAL FUND OPERATIONS

The SEC would like to separate the economics of the mutual fund business into two parts—investment management and distribution. It says the industry charges too much and makes too much from management, and charges too much for distribution, although it concedes that we make little, if anything, from the latter function.

This distorts the picture. When the mutual fund business is viewed as it really is—an integrated operation—a vastly different picture is seen.

The following table shows IDS's after-tax profit from mutual fund operations for each of the past five years and for 1967, as annualized from the first eight months, and measures that profit against gross income from mutual fund operations, mutual fund assets and mutual fund sales.

	1962	1963	1964	1965	1966	8 months 1967 (annualized)
Profit from mutual fund operations.....	\$4,633,579	\$4,152,025	\$5,850,418	\$7,375,497	\$7,624,910	\$6,550,000
Ratio of profit (percent):						
To gross income....	11.85	10.52	11.4	12.23	13.48	13
To average net assets.....	.15	.11	.14	.15	.15	.12
To mutual fund sales (excluding reinvestment of dividends and capital gains).....	1.33	1.30	.120	1.22	1.42	1.6

Companies of comparable size elsewhere in the financial community are vastly more profitable. For example, banks and insurance companies with comparable assets enjoy profits four times those earned by IDS from its fund operations. The facts will not support the SEC's charge of overpricing and excessive profits in the fund business. They do not justify the claim of need for drastic restructuring of the industry, with admittedly incalculable consequences, which the SEC proposals would produce.

Mr. LOEFFLER. Mr. Chairman, members of the committee, with me is Mr. Joseph F. Grinnell, general counsel of Investors Diversified Services.

As you have suggested, rather than read the entirety of the statement, in deference to the committee's time I will endeavor to summarize it and make certain points which I feel perhaps should be particularly made and stressed rather than cover the entirety of the statement.

Mr. STUCKEY. Without objection.

Mr. LOEFFLER. I am a director and vice president-law of Investors Diversified Services, of Minneapolis. I think I should first describe just a little bit about IDS, as Investors Diversified Service is commonly referred to.

IDS is the creator and sponsor of four mutual funds for which it serves as the investment manager and as the sole and exclusive distributor of the funds' shares. The assets of these four funds collectively total about \$6 billion, and constitute about 15 percent of the total assets of the mutual fund industry.

IDS distributes the shares of these funds through its own sales force of approximately 4,000 men and women who work full time solely as career sales representatives of IDS. The sales of the IDS sales force amount to approximately 15 percent of the total sales of the mutual fund industry. They distribute throughout all of the 50 States.

I would like to comment first on the Commission's proposal with respect to the sales load, particularly to reduce the sales load to a statutory maximum of 5 percent. Before doing so, I should mention that IDS is a fully integrated distribution system. By that, I mean that IDS performs all of the distribution functions from that of principal underwriter down to the direct sale to the customer and subsequently the servicing of the customer account. It is all performed by IDS.

A description of the IDS distribution system is contained in the written statement, particularly on pages 6 to 10, but I shall not go into that at this moment.

Mr. KEITH. Did you start off this way or is this something that finally developed?

Mr. LOEFFLER. IDS has always distributed in this manner. IDS was formed in 1894, and was from then through 1940 a distributor of securities through its own direct sales force. In 1940 it founded its first mutual fund, and began the distribution of the shares of those mutual funds through its sales force in the same manner as it had theretofore operated.

I am not sure that throughout its entire history the IDS sales representatives were full time. That has been the practice of IDS for many years now.

The SEC has grounded its proposal for a statutory maximum of 5 percent on what it refers to, as I understand it, the theory of perverse competition. In substance it seems that the Commission's charge has been that the underwriters, the principal distributors of mutual funds, those who establish the offering price and then seek to market the shares of a particular fund, do not compete with each other for the customer dollar which, if they did, would have the tendency to bring the sales charge down. Rather, the Commission says it is a perverse competition, that these competitors compete with each other for dealer favor, for the favor of the dealers who in turn sell the funds' shares, and therefore the competition tends to push the sales load up, in order to enable the underwriter to pay more to the dealer.

I make that point because it is totally inapplicable to IDS. We do not compete for dealers. Dealers do not sell the funds' shares distributed by IDS. Only the IDS sales representatives sell the shares of the IDS-distributed and IDS-managed funds; so there is no competition for dealer favor.

Mr. STUCKEY. Do you, in a sense, do your own underwriting?

Mr. LOEFFLER. Yes, sir; the entire part.

Mr. STUCKEY. Do you mean to say that you no longer sell as broker-dealers individual shares of stock?

Mr. LOEFFLER. The IDS sales representatives sell mutual fund shares of the IDS-managed funds only, and those funds may be—

Mr. STUCKEY. But do they not sell—

Mr. LOEFFLER. Other securities?

Mr. STUCKEY. Yes.

Mr. LOEFFLER. They sell a face amount certificate, which is issued by an IDS subsidiary. They sell life insurance, which is issued by a wholly owned life insurance subsidiary of IDS. They sell no other securities.

Mr. STUCKEY. Only IDS?

Mr. LOEFFLER. Only IDS products; yes, sir, and these products may be purchased only from the IDS sales representatives.

Mr. KEITH. Is this life insurance business, that you have, the typical stock company?

Mr. LOEFFLER. Yes, sir.

Mr. KEITH. Or is it something geared in especially with your mutual fund business?

Mr. LOEFFLER. No, sir. It is all forms of life insurance, ordinary life, term life, reducing life, sold independently of a purchase of fund shares.

Mr. KEITH. No tie-in sales?

Mr. LOEFFLER. No, sir.

Mr. KEITH. There are some that have tie-in sales, are there not?

Mr. LOEFFLER. There are, although I am not terribly familiar with them, sir, and I am a little reluctant to comment. I am not sure that they would strictly be what you call a tie-in in the sense that neither may optionally be purchased separately from the other. I am just not sure. I think a tie-in means that you cannot purchase one without the other, at least as I usually understand the term, but I may be wrong on that, sir.

I may say on this, in response to your question, the IDS sales philosophy is based on what they call a four cornerstone approach, and that is that the average person should have money in the bank for immediate emergencies, cash, that he should have life insurance, that he should then have some fixed savings program of a fixed type, and then that he should have some equity investments such as a mutual fund as a hedge against inflation. That is the basic sales philosophy of the IDS sales representatives, and they are in a position to offer any form of these various investments.

Mr. KEITH. It was not inadvertent when you left out life insurance?

Mr. LOEFFLER. No, sir; life insurance I think is second. After cash in the bank, life insurance is in the foremost of the program.

Mr. STUCKEY. Is this a contractual type of plan that the salesmen are selling?

Mr. LOEFFLER. We also have a contractual plan, although I was not referring to that at the time. I can comment on that separately. It is slightly different than the industry format.

Mr. STUCKEY. So you would offer just every type I guess except a no-load?

Mr. LOEFFLER. Everything except a no-load, yes, sir, within the IDS family of packages, family of products.

Mr. STUCKEY. Right.

Mr. LOEFFLER. I thought it necessary and essential to point out the fact that IDS does not compete for dealer favor because the IDS maximum sales load is 8 percent, and it graduates down from 8 percent. A description of the effect of various options on the average commission income to IDS is contained in my written statement, particularly on pages 10 to 13. Rather than go into those, however, at this moment, the particular point I wanted to make related to the question of why, if IDS does not have to compete for dealer favor, does it necessarily have a sales load as high as 8 percent as the starting maximum.

The answer to that is solely a question of economic necessity, and this is the primary point which I did wish to make and to stress.

On page 13 of the written statement, if you have it before you, are the statistics with respect to the gross income, expenses, and then net income to IDS from distribution of mutual fund shares. This shows the data for the years 1962 through 1966, and for this year to

date; it shows that throughout that period, for 5 of those years, IDS lost money from distribution in 3 of the 5 years, made a slight profit in 2 of the 5 years, and in 1967 so far is again in a loss position.

Out of a total gross income from the sales load, from the commission charges of over \$172 million during that period, the net income to IDS was \$65,000. It becomes abundantly clear that there is no profit to IDS from the distribution of fund shares, notwithstanding a maximum of 8 percent sales load as the starting point.

Mr. KEITH. Except of course as you get additional funds over which you can—

Mr. LOEFFLER. From the management fee?

Mr. KEITH. Yes.

Mr. LOEFFLER. We do realize a profit from the management fee. Otherwise, we would not even be in the business.

Mr. KEITH. This is the kind of point I have been making right along through these hearings, that the genesis and the sustenance of these mutual funds is in the investment company.

Mr. LOEFFLER. Yes, sir; and this is a subject which I would like to get to as a separate point. Perhaps I could get to it later unless you would wish me to get into it at this moment.

Mr. KEITH. Not at all. Go ahead.

Mr. LOEFFLER. The question on the distribution side that immediately arises in view of this result to IDS is what do our sales representatives make, since the major expense is the commission to the sales force, the sales representatives and their supervisors. Are they making exorbitant or excessive incomes?

On page 14 of the statement, is the average income of the sales representatives of IDS and of the district sales managers of IDS for the period from 1962 to date.

The difference between a sales representative as shown there and a district sales manager is that a district sales manager will spend approximately 50 percent of his time in sales and about 50 percent of his time supervising other sales representatives, generally an average of about five sales representatives to a district sales manager.

As indicated there, the average income to an IDS sales representative in 1966 was \$8,000 per year, and for a district sales manager was \$14,000. These are full-time career sales representatives. I think it is abundantly clear that this is a minimum amount necessary to attract and to keep well-trained, qualified career sales representatives.

As an actual matter and in practice, what happens is that the sales representatives, those who are qualified and able, naturally move on to becoming district sales managers, because \$8,000 normally will not retain a good man on a permanent basis, and that is the progression which occurs.

The entirety of the point which I wish to make from this is that it is abundantly clear that the reason for the level of our sales loads is strictly a matter of economic necessity. It is a matter of the economics of distribution, the amount which is necessary to maintain an adequately compensated and an adequately trained and a properly supervised sales force.

I might say that we would be happy, too, if we could cut that maximum and reduce it. It would be good business and we would like to do

so. We have studied ways in an endeavor to do so, but we simply have not yet, to date in any event, been able to devise a means by which we could reduce the maximum perhaps, and level it out.

I would like to turn for a moment to a comment on the impact of this proposal.

First of all, of course, the proposal to reduce the maximum sales load to 5 percent would mean a reduction in the income of the sales representatives, a reduction of approximately 35 percent, and we simply would not be able to keep them on that basis, but that alone is not the only consequence.

Mr. KETH. Excuse me a second if I may, Mr. Chairman. It is quite significant, it seems to me. These men are really part-time salesmen insofar as mutual funds are concerned. They are full-time salesmen, but they spend a part of their time on mutual funds and a part of their time on life insurance.

Mr. LOEFFLER. Yes, in that sense they are. When they call on a customer, they are in a position to offer the full line of ISD products, which includes life insurance. The \$8,000 figure is the income of the average sales representative from all sources. Most of that is from the sale of mutual fund shares. When I say most, I believe that over 70 percent, 72 percent of their income is from the sale of mutual fund shares.

Mr. STUCKEY. You do not think then, if it were lowered to 5 percent, that this would tend to increase sales?

Mr. LOEFFLER. No, sir. If we thought it would we would do it now. What it would eliminate in particular would be the ability of the sales representative to call on the small investor, he who has only a small amount to invest.

Mr. MOSS. Let me express my apologies to you. It was necessary that I be in attendance at another subcommittee which I chair, in order to get out a rather pressing report.

Mr. LOEFFLER. Yes, sir.

Mr. MOSS. I do apologize.

Mr. LOEFFLER. The further point that I wanted to make, before leaving this question of the impact of the Commission's proposal on the sales load, is this: Not simply that it would reduce the income of the sales representatives. That is of concern to us and it is of concern to our sales force, of course. But the heaviest impact of the proposal would be upon the full-time career security sales representatives such as those at IDS. These would be the men who would have to leave the business and seek employment elsewhere or other means of income. The impact would be to leave the field primarily to the part-time securities salesman, to what you might call the moonlighter, the man who has a regular job, a regular income and salary, and then sells mutual funds at night as a means of supplemental income, and the tendency of this bill would be to leave the field to them.

This, I think, is directly inconsistent with what were the objectives of the 1964 Securities Act Amendments, which sought to upgrade the training and the qualification and the supervision of security salesmen.

My company, and I think the industry generally, cooperated with the Commission in support of that act and of those objectives, but the impact of this proposal runs directly to the contrary.

Mr. WATKINS. Mr. Chairman?

Mr. MOSS. Mr. Watkins.

Mr. WATKINS. I would like to ask a question of you, if you would care to answer it, if you are in a position to.

Do you think that the Congress of the United States has any legal right to regulate this money?

Mr. LOEFFLER. By legal right, if you mean constitutionally—

Mr. WATKINS. Constitutionally, do they have a legal right to do it?

Mr. LOEFFLER. I see no constitutional question, sir.

Mr. WATKINS. You see none?

Mr. LOEFFLER. No, sir.

Mr. WATKINS. Thank you.

Mr. MOSS. As a matter of fact, you are operating under a congressionally imposed ceiling at the present time, are you not?

Mr. LOEFFLER. With respect to contractual plans, that would be so; yes, sir.

I would like if I may to make a few comments with respect to the Commission's proposal relating to the management fee. The proposal, as I am sure you are familiar, is merely to put into the statute a statutory requirement that management fees be reasonable. Certainly I, and I think all responsible businessmen, would feel that management fees should be reasonable, and indeed any businessman would feel that the price for his product or his service should be reasonable.

The question really is one of upon what system shall we rely to produce a reasonable price level? Basically there are, of course, two systems which can be utilized. One is a system of free competition, such as generally prevails in the United States and in most industries. The other system is a system of regulation.

The proposal, in effect, is to substitute a system of regulation for the system of free competition which presently prevails in the industry. And that is the question.

I do not say that critically. I say it only in order to pose what I believe is the issue. The SEC states that the reason—well, let me first make one further comment on that.

When I describe the proposal as regulation, it is for this reason: This proposal would give to the courts or to the Commission, which one is immaterial, the power to establish the price for the investment services being sold, the power to establish the price independently of a price which might have been agreed upon between the suppliers of the service, the management companies, and the purchasers of the service. Now whenever a third party who is not a party to the transaction, such as the court as it would be in this case, is given the power to set the price, that is regulation, and that is what we would have here.

The SEC, in support of its recommendation that we go to a regulatory system with respect to management fees, has taken the position and charges that the present system is not working in the interest of the consumers, the ultimate consumer, the fund shareholder who uses the services and pays the charge. The Commission's charge is that it is not working effectively because, if it were, as the funds have grown in size over these past few years, the inevitable conse-

quence would have been to reduce the charge to the investor, to reduce the management fee, the rate, the per dollar rate.

My conviction is—and this is what I wish to point out—that the present system is working. I think had the SEC made its charge 10 years ago, there might have been a great deal more validity to the charge, but I think that the charge is predicated upon circumstances which might have obtained 10 years ago, but which no longer obtain in the industry.

Let me refer specifically to the present situation as it exists at IDS.

During the past 5 years, since 1962, four new sets of contracts relating to the management fee have been put into effect, each one successively reducing the per dollar rate of cost to the investor. One of them related to an IDS subsidiary which became a member of the Pacific Coast Stock Exchange, for the purpose of being able to handle portfolio brokerage transactions for the funds. At the time that that was done, the contracts were amended to provide that the management fee would be reduced by an amount equivalent to 100 percent of the net profits from the handling of the fund brokerage transactions.

The other three contract changes during the past 5 years were the result of rather extensive negotiations between IDS and those directors of the mutual funds who are unaffiliated in any way with IDS.

There have been other factors which have influenced the present trends of management fees. These include increased public awareness, increased awareness on the part of the managers, the general maturity of the industry, and increased competition.

As a result of all of these factors and these contract changes, on page 21 of the written statement which I have submitted are the figures showing the effect at IDS, and the benefits which have accrued to the million fund accounts which IDS has.

In 1962 the expense ratio for the IDS funds was 0.53 percent. That covered all expenses of the funds, fifty-three hundredths of 1 percent. Under the IDS contracts IDS absorbs all expenses of the funds out of the management fee so the management fee and the expense ratio are exactly the same. In this current year, the expense ratio has been reduced down to 0.30 percent. That is a reduction of 43 percent. What does this mean to the individual shareholder, to our individual IDS customer?

In 1962 it cost \$26.50 total expense for the maintenance of an account of \$5,000, which is our average account. In 1963 it was \$25. In 1964 it was \$22, in 1965 \$20, in 1966 \$17, and currently this year it is running at a rate of \$15, a 43-percent reduction. There have been substantial economies. These have been passed on to the funds shareholders.

It is our conviction that this present system is working and is working well and effectively.

Mr. Moss. Would you tell me where in this system the force of competition enters?

Mr. LOEFFLER. Yes, sir.

It has its bearings in many ways. One is when we sit down to review our management contract annually; we are very much aware of the cost of equivalent type services, primarily the charges being

charged by other fund managers. There are approximately 100 sponsors of mutual funds, each competing with the others for the investor dollar. We sit down and we review this, and we have it very definitely pointed out to us if another fund manager is using a different system, providing a service here that we do not provide, or charging a lower cost; in turn when we reduce our fees we know that others are having that called to their attention, and so the competitive forces do work.

We have it called to our attention from our sales representatives also. They are out meeting the public, selling these funds to their customers. Each sales representative generally represents or services about 250 accounts. These are generally customers of his who live in the community in which he lives. Most of his new accounts come from referrals from them. He in turn looks at this.

Mr. Moss. My question goes to the forces of competition in providing the management services to the fund, and other than the fact that there is an awareness on the part of a board of directors or the directors of the fund of general practices in the industry, where does the arm's length competition come in?

Do they cover offers from other managers?

Mr. LOEFFLER. They have had no occasion to do, sir.

Mr. Moss. Well you are saying then that all management—

Mr. LOEFFLER. They have the power to do so.

Mr. Moss. Can you cite me any instance in any fund where that has happened?

Mr. LOEFFLER. I think there was a reference here the other day, sir, to a fund which changed its investment managers a couple of years ago. Generally speaking, sir, it does not happen, and I do not mean to contend, and would not suggest, that the unaffiliated directors of the funds—that is, those who have no affiliation with the management company—should sit down and say, "We can get a better deal from another management company or from a bank or someone else over here who will manage this for 2 cents less. Therefore, we shift over here."

Mr. Moss. They do not really know, do they, because they do not invite any competing offers—

Mr. LOEFFLER. It is all published, sir.

Mr. Moss (continuing). Or proposals?

Mr. LOEFFLER. This information is all published.

Mr. Moss. Do they entertain any proposals?

Do you go out and submit proposals to other funds?

Mr. LOEFFLER. To other funds?

Mr. Moss. To undertake management activities for them?

Mr. LOEFFLER. No, sir.

Mr. Moss. You do not.

Mr. LOEFFLER. We have never considered this.

Mr. Moss. Do you know of anyone else who does?

In other words, we are going to use terms here. I think if we are going to talk about competition, let's bring it down to—

Mr. LOEFFLER. That would be one form of competition and I am not contending that that form—

Mr. Moss. I am using it more or less in the orthodox sense. Do you actually compete in that market for that particular account? Let's

say it was an advertising account. We know that there is good sharp competition to get it.

Now it is in a different sense that you use the word "competition" here, is it not?

Mr. LOEFFLER. It is a different form of competition that I am addressing myself to; yes, sir.

Mr. MOSS. Let's say it is less competitive competition. You are saying it is competition of performance.

Mr. LOEFFLER. No, sir. That would be only part of it. No, sir. I think if I might try to clarify what I am referring to, there are approximately 100 managers of mutual funds, 100 different companies which are managers. What we compete for essentially is the investor dollar of the customer, the ultimate customer.

In doing so, the price of our product to that customer is an aspect of that product. We do not sell to the customer solely on a question of price, as in many other types of commodities which are not sold on price alone, but it is an aspect of it.

We compete with 100 other sponsors of mutual funds who compete for the customer favor, the ultimate consumer, for his dollar, and the cost of our service, which is clearly disclosed on the prospectus, is an aspect of the service that we are selling. It is an aspect of the product.

Mr. MOSS. I have no doubt that as it shows in the prospectus that it is an aspect of the service. I am not always certain how much emphasis might be placed on that, how much of a comparative discussion would be undertaken with a prospective buyer. I would assume that the good salesman would duck that point and go on more to the items of more immediate benefit to the buyer rather than getting into the technical details of management and things of that kind.

Mr. LOEFFLER. No, sir; but the cost he is required to point out, and it is an aspect of it.

Mr. MOSS. It is there.

Mr. LOEFFLER. It is there.

Mr. MOSS. And so it is recognized, but in a comparative sense is it discussed?

Mr. LOEFFLER. It may or may not be, sir.

Mr. MOSS. I don't think a salesman with a relatively unsophisticated buyer would enter into a discussion of that type since it might tend to discourage or confuse him.

Mr. LOEFFLER. I think the cost is very low so we would regard it as a virtue.

Mr. MOSS. I think you have an excellent plan. I am not criticizing it.

Mr. LOEFFLER. I understand.

Mr. MOSS. We are just getting into a discussion of the type of competition.

Mr. LOEFFLER. Yes, sir.

Mr. MOSS. That is brought into play here, because really it was an expression on the part of the SEC that the element of competition as they had hoped it would develop had not developed.

Mr. LOEFFLER. Yes, sir. My contention is that there is an effect from it. Let me go on if I may to clarify that, sir.

Mr. MOSS. Certainly.

Mr. LOEFFLER. In addition to that form of competition, we do have these very extensive and prolonged negotiations with a committee of the fund board. There is reference to them in my written statement at some length. During those discussions and those negotiations, the charges made by every other fund manager are reviewed at some length. Are we being competitive? Are we meeting them? When we reduce ours, I know this happens elsewhere, and it is the pressures of this and the combination of all these circumstances which result in the continuous lowering of the charge.

I think the fact that we have reduced the cost to our investor, per dollar of investment, by more than 43 percent in the last 5½ years would indicate that something must be working, and working effectively. Else I think I run the charge that IDS has become an eleemosynary institution, and if so, then we would have a great deal of difficulty in answering to our own 14,000 public shareholders. I think that the results indicate the operation and effectiveness of the system.

If I might go on more directly to the Commission's proposal on this, the question would immediately arise, I am sure, that if we believe, as we do believe, that our charges are reasonable, and that we would have no difficulty in justifying and sustaining a challenge upon those charges under a standard of reasonableness, why do we object to putting that standard and that requirement into the statute. I would like to address myself to that briefly, hopefully briefly, with respect to a few points.

As I have said, once that is put into the statute, it substitutes the regulatory system for the present system, and the question becomes then, who is going to determine the reasonableness of the price level? It no longer becomes those who are engaged in the business and who have the responsibility for the conduct of the business, but it becomes some third party who is not a party to the transaction. Under this proposal initially a judge, any one of a thousand judges throughout the United States—I am sorry, sir, did I interrupt?

Mr. WATKINS. No, you go right ahead. You are hitting on my question that I asked you. Please continue.

Mr. LOEFFLER. Now there are several aspects of this particular proposal which are quite unique. I do not suggest that the mere fact that it is unique answers the question as to whether it is wise or not, but I think it is important to a determination of that to recognize these facets of the proposal, in order to evaluate it.

The first is that it creates a unique function for our judiciary. Historically, our courts have taken the position that they will not substitute their judgment for the business judgment of directors or those engaged in running the business, absent some showing of malfeasance or something of that nature.

This proposal not merely empowers the court to substitute its judgment for that of the directors of a corporation. It directs and mandates that the court substitute its business judgment upon the pricing of a product for the business judgment of the directors who had theretofore agreed to it. Again, I am not questioning whether the courts might or might not be competent to do so, but this historically has not been and is not generally the function of our judiciary.

There is a second aspect of this proposal which again is unique and which I think we should be aware of, and that is that it is a complete

innovation in our present economic system in this sense. It puts a regulatory pattern or system on an industry which is not a utility, which is an industry in which open and free competition exists. There are 100 fund sponsors today. New ones are entering the business daily. There is no restriction upon the entrance to the business. Neither is it a utility in the sense that one must be franchised, nor that only one exists, nor that the customer must purchase the service as a matter of absolute necessity.

So far as I have been able to discover, this would be the first statute in the history of the United States, other than in wartime, where Congress would have imposed a regulatory system on a competitive industry.

There is a third point which I think also should be borne in mind in evaluating this proposal, and that is the effect that it has as a nullification of State corporate law. A fund management contract will have been offered by the management company and agreed to by it. The purchase is purchased after disclosure to the fund shareholders. The contract is approved annually by fund directors, and any change approved by the stockholders of the fund themselves.

Now then, this proposal directs the court to completely disregard the effect which State law gives to shareholder approval of a fund contract. It nullifies State law and the effect which State law gives to shareholder approval. This applies to all 50 States.

Now the point which I would like to make is this. This is premised by the SEC on the contention that when shareholders vote upon a matter submitted to them by the management of a corporation, in the absence of a proxy fight the vote is meaningless and routine. Therefore, the Commission says no effect should be given to it.

Well, if there is validity to that argument and to that position, it is certainly equally applicable to shareholder approval of transactions of all publicly owned corporations.

There is nothing unique or distinctive about mutual funds in this regard as distinguished from any other publicly held corporation.

Now if Congress is going to declare as a finding, which it does when it accepts that position, that shareholder approval in a publicly owned corporation is a meaningless act, and should not be given the effect which the laws of our 50 States give to it, then such a congressional declaration portends the same sort of action generally, because if the shareholders of mutual funds need to be protected from the effect of their own vote and own approval, so do the shareholders of General Motors, of A.T. & T., and of any other publicly held corporation.

I think that this finding, whether it be wise or unwise, be that as it may, has portent far beyond the mutual fund industry. It has implications in the general corporate law, the creation of a Federal common law in this area or a Federal corporate law nullifying the corporate law of our 50 States. Again, I mention this only because I think there should be awareness of it as a consequence of this proposal.

Mr. WATKINS. May I interrupt you? Then you do agree? You said before that you had no quarrel. In your testimony now it seems you do have a little quarrel.

Mr. LOEFFLER. I beg your pardon, sir. I think I may have misspoken myself. I said I had no quarrel with the proposition that management fees should be reasonable.

Mr. WATKINS. That wasn't my question. I asked you a question, if you thought under the law it was constitutionally proper to interfere with this fee. I know and you know that under section 22 of the Investment Company Act of 1940, I am questioning whether they have the right. Under that act it was a voluntary self-regulatory body to permit its members to distribute mutual funds and shares of the price including unconscionable or grossly excessive sales charge.

Mr. LOEFFLER. Let me clarify, sir. When I answered your question before—

Mr. WATKINS. I understood you to say no, that you had no quarrel with it.

Mr. LOEFFLER. I think that Congress constitutionally has the power to do this, to enact such legislation. I am not saying that I agree that it should.

Mr. WATKINS. I don't agree that they have the power.

Mr. LOEFFLER. There may be some question about it.

Mr. WATKINS. There is some question in my mind and I could be wrong, of course.

Mr. LOEFFLER. As a lawyer I had not personally felt that there was a constitutional question as to congressional power on the issue.

Mr. WATKINS. You go right ahead.

Mr. LOEFFLER. But I certainly do not agree that it would be wise to do, that it would be wise legislation.

Mr. WATKINS. All right; you go ahead.

Mr. LOEFFLER. There is one additional point which I would wish to make with regard to this proposal. Again it is one of which I think there should be awareness. In reality and in practice and effect, this bill would give the SEC, either apart from or in addition to the courts, the power to set management fees. It could do this through a threat, through the threat of litigation, and through the control that it has over proxy and prospectus requirements.

The SEC would, I think, and certainly any lawyer who has dealt on a continuous basis with the SEC would, I believe, recognize that the SEC would realistically and pragmatically have the power to impose its will as to what management fees should be under this proposed statute. I am not being critical of the SEC when I say that it would have that power, and that it would have that effect. I think under the statute it would probably be the duty of the SEC to attempt to do so. The point I wish to make is this. The effect would then be to give the power to set the price for an industry to an agency. Yet, at the same time the statute sets up no procedures, no mechanics, and no safeguards with respect to the exercise of that power. It is an inevitable consequence, but yet the statute does not address itself to the consequences that would occur.

This, again, I think, is a matter of which the committee must be aware in evaluating the proposal and the merits of it. I think the consequences of all of this, of this proposal, would undoubtedly produce a great deal of uncertainty. It would undoubtedly breed a rash of litigation, and it would undoubtedly make it difficult for those engaged in the business to obtain competent and qualified directors, if their judgment is to be disregarded, and they are then to be subjected to the litigation that would undoubtedly ensue.

The conclusion which I would draw from all this, and my comment in conclusion is that on behalf of IDS, we would urge the committee not to displace a system which we believe is working well and is working effectively, with a new and an untried system, having unknown and unforeseeable consequences.

Mr. Chairman, this would conclude the remarks which I had on the points which I particularly wanted to stress in my oral comments. I shall be pleased to answer, or to attempt to answer, any questions which the committee might have.

Mr. WATKINS. Mr. Chairman, I have a question.

Mr. MOSS. The Chair will recognize the gentleman from Pennsylvania.

Mr. WATKINS. Thank you, Mr. Chairman. I just wonder what your opinion would be. Let's suppose now, let's take for granted that this bill is passed, what effect would it have upon you in employing salesmen? Could you employ salesmen on this basis of 5 percent?

Mr. LOEFFLER. No, sir; I don't believe that we could. We would have to go to some kind of a part-time salesman system, I think.

Mr. WATKINS. You would have to do away with your regular trained salesmen and go to part-time salesmen.

Mr. LOEFFLER. We would have some who undoubtedly could continue under that, some, but we could not maintain the distribution system that we now have in the manner in which we operate on that scale; no, sir.

Mr. WATKINS. In other words, I could be working for a grocery store and selling insurance at night.

Mr. LOEFFLER. Yes, sir. I think we would almost have to go to that kind of a system.

Mr. WATKINS. Would you be left in a position where you would say that that person would not be trained properly to consummate sales?

Mr. LOEFFLER. I don't think we could train them the way we do today; no, sir.

Mr. WATKINS. You don't?

Mr. LOEFFLER. If I might elaborate one moment. We figure that it costs IDS approximately \$15,000 before we have a sales representative trained, validated, and on a permanent basis. We subsidize the salesman during his first year and in his training period. Our training material—one set of it would stack to here [indicating]—is extensive because our endeavor is to get men who remain full-time career sales representatives. We simply couldn't do it and the kind of men we want couldn't earn their living.

Mr. WATKINS. I wouldn't think so, not from your figures which you give us on one of these pages, 12 or 13, where you say that \$7,233 is the salary, the complete salary for a man for a year. You would be reducing that salary.

Mr. LOEFFLER. That would be reduced to \$5,200 a year under the 5-percent proposal.

Mr. WATKINS. From \$7,233 to \$5,200?

Mr. LOEFFLER. No, sir; I take it back. The reduction to \$5,200 would be from the 1966 figure of \$8,100. From the 1967 figure it would be much less.

Mr. WATKINS. In other words, it would injure your business. Now would you go as far as to say you would get out of the business if this

happened? Let's say the law went into effect. Would you have to get out of business or could you continue?

Mr. LOEFFLER. I think we would struggle along somehow, but I don't know how; but I think we would find some way. It would just have to be done in an entirely different manner and I think it would be done in a manner which would not enable us to provide the same protections to the investing public that we now do under the requirements of the 1933 act and the 1964 act amendments. We just couldn't do both. We couldn't maintain quality sales and a well-trained sales force and try and stay in business under that schedule.

Mr. WATKINS. Thank you very much. That is all right now, Mr. Chairman.

Mr. MOSS. Mr. Blanton.

Mr. BLANTON. I have no questions.

Mr. MOSS. Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman.

Do I understand you to say that the shareholders of mutual funds have the usual State common law protection or statutory law protection that a shareholder has in the ordinary corporation?

Mr. LOEFFLER. Yes, sir; the law is exactly the same.

Mr. KEITH. But is the scheme the same?

Mr. LOEFFLER. Yes, sir.

Mr. KEITH. I think that might be what this is all about.

Mr. LOEFFLER. Well, then, perhaps it would be helpful if I elaborated a bit, sir.

Mr. KEITH. I think it would be.

Mr. LOEFFLER. Let us say, for example, that X Corp., whatever it is, adopts a stock option plan. That would be approved by the directors of the corporation, and the approval would be by those directors who are not eligible to participate in the stock option plan. Probably some of the directors would be eligible, but the majority would not be.

Mr. KEITH. Let's keep the situation as closely parallel to—

Mr. LOEFFLER. To mutual funds?

Mr. KEITH. To the mutual fund industry. We are talking about—

Mr. LOEFFLER. A management contract?

Mr. KEITH. The management contract. We are talking about the directors of the fund having to buy services elsewhere, and a minority stockholder having the right to sue.

Mr. LOEFFLER. Yes, sir.

Mr. KEITH. And to prove in court that there was a conflict of interest involved, and that the principals should declare that conflict of interest and lean over backward to protect the shareholders.

Mr. LOEFFLER. I don't think we will have any quarrel on this at all, sir. Perhaps I can clarify that.

Mr. KEITH. You are speaking from an industry point of view, not just from IDS.

Mr. LOEFFLER. Yes, sir, from a legal point of view that would be applicable generally and particularly to the industry, as a lawyer. When the management contract is approved, and it must be approved annually, the approval must be given by those directors of the fund who are not in any way affiliated with the management company. Now let me be a little more specific.

Mr. KEITH. You mean the unaffiliated directors.

Mr. LOEFFLER. Yes, sir.

Mr. KEITH. Who appoints them?

Mr. LOEFFLER. Well, they are nominated normally. The usual procedure is that a board, in submitting its slate of directors to the shareholders annually, the board nominates the board, so they would be in effect continuously self-appointing. May I be specific on that, sir?

Mr. KEITH. Would they be likely to be reappointed if they chose to hire another firm than that which currently uses it, because the other firm offered to give them the same services at less cost?

Mr. LOEFFLER. They would have the power within themselves. May I be a little bit more specific, sir? Let me take IDS, for example. The IDS funds each have 12 directors. Of those 12 directors, two are affiliated with IDS. None of the other 10 directors are affiliated in any way with IDS.

Now when those funds select the slate of directors for the succeeding year, the nomination is made by the 12. Obviously the majority of those directors, and therefore the control of the board for that purpose, is among those who have no affiliation with IDS. The power resides in those who have no affiliation with IDS because they are the majority.

Mr. KEITH. I understand that, but this does not seem to me to be the usual situation that obtains in the usual corporate structure. It seems to me to be a unique arrangement worked out by this committee earlier in its history to provide for the continuation of the mutual fund industry.

But it seems to me that the standard to which they must refer—namely, either stockholder approval or unconscionable compensation—the stockholder is not in the same situation. He has a yes or no vote ordinarily on the approval or disapproval of the management fee, and he is not dealing with the same situation as exists in the usual stockholder case.

Mr. LOEFFLER. Let me perhaps add then, sir, if in fact the approval of the management contract is by a board of directors of the funds, of which a majority are affiliated with the management company, in other words, so that you really have—

Mr. KEITH. Even if this law didn't exist as it is at the moment.

Mr. LOEFFLER. No, sir. Even if the Investment Company Act didn't exist, the law would be the same in this area.

Mr. KEITH. All right.

Mr. LOEFFLER. The Investment Company Act does not create this situation. This would be the law without it.

Mr. KEITH. The law would still be there, but I think that they would have to turn to prove—there was a case that was pointed out to me about the American Tobacco Co., where they had an arrangement with the president of the company, a formula under which this individual was getting \$5 million a year. A stockholder took this case to court and was able to prove that this wasn't reasonable compensation, because he was not giving any services in connection with this, and the compensation was cut down considerably. Are you familiar with this case?

Mr. LOEFFLER. I am familiar with the case. The effect was slightly different, sir.

Mr. KEITH. Well, the law to which they turned was—

Mr. LOEFFLER. State law.

Mr. KEITH. A State statute, and even though the law there may be different than it is here, the law here I believe talks about unconscionable, does it not?

Mr. LOEFFLER. The unconscionable provision in the Investment Company Act, sir, relates to another matter. It relates to the sales load area.

Mr. KEITH. The sales load area.

Mr. LOEFFLER. It does not relate to—

Mr. KEITH. Not to this.

Mr. LOEFFLER. No, sir.

Mr. KEITH. So the only subject we are really talking about is whether or not there is a bona fide similar parallel between the shareholders of a mutual fund and the stockholders of a corporation.

Mr. LOEFFLER. I think it is exactly the same, sir. I think they have exactly the same—

Mr. KEITH. There is in these many volumes of hearings that have been presented to us a dissertation on this subject, but that is one of the arguments I think that Mr. Cohen has advanced for this legislation, that there is not truly an arm's-length relationship, and you are insisting that there is the usual arm's-length relationship.

Mr. LOEFFLER. Yes, sir. If there is not an arm's-length relationship, sir, then a stockholder wouldn't have to prove waste.

Then he can go right to the fairness of the contract. That is the law today, if there is not an arm's-length relationship.

Mr. KEITH. I am not an attorney, and I am not sufficiently acquainted with it. We will later on with the advice of counsel get into this, whether or not there is truly this arm's-length relationship which you brought out. You drew the parallel, and having raised the question, I would like to explore it in some depth.

Mr. LOEFFLER. Yes, sir; it is a rather complicated subject to try and clarify briefly.

Mr. KEITH. You pointed out about the reduction in rate to improve the product. What is the relationship if any to reduction in rate in the cases that were brought by Pomerantz and others?

Mr. LOEFFLER. I think what happened, if I may go back on this—

Mr. KEITH. Was there any reduction in rate industrywide as a result of the Pomerantz suits?

Mr. LOEFFLER. Yes, sir; I think they had effect.

Mr. KEITH. Mostly as to the shedding of light on the subject, rather than competition?

Mr. LOEFFLER. Well, I think they were unrelated to the competitive aspect.

Mr. KEITH. It invited the shareholders' attention.

Mr. LOEFFLER. I think it invited the industry's attention. I think what had happened actually, sir, was that this industry grew enormously during the 1950's. It was really a very young industry. The effect, as is true in almost any situation such as that, is that generally your competitive effects and your price adjustments lag behind an enormous sudden growth. I think they were just coming into play in the 1960's when this rash of litigation broke out. I think there is a possi-

bility that the litigation held up what would have been the normal flow, because as you can imagine, no lawyer wants to cut the fee when he has pending litigation challenging the fee itself. Not until the litigation was over could things go back to what would be the normal expected economic consequences.

Mr. KEITH. If you were counsel for Dreyfus Fund, would you recommend that they reduce their fee from one-half of 1 percent to something lower than that?

Mr. LOEFFLER. I would never have recommended to them that they do it voluntarily while the litigation was pending.

Mr. KEITH. That was some years ago.

Mr. LOEFFLER. No, sir; it was just settled recently and I think the settlement is pending on appeal today, but as to whether they should do it now or in the future is a subject which I will have to leave to counsel for Dreyfus Corp. I am not particularly familiar with their situation.

Mr. KEITH. They have stockholders in the management company and their loyalty is to the shareholders.

Mr. LOEFFLER. So does IDS, sir. We have over 14,000 public shareholders.

Mr. KEITH. Yes, and they would have to prove to their shareholders that they would get more fees by cutting that rate than the fees that they are now getting, in order to justify it.

Mr. LOEFFLER. I don't think it is—

Mr. KEITH. If you take the whole ball of wax and the cost of the load in order to get this operation into the market the really great benefits have been in the improvement in portfolio and investment policies.

Mr. LOEFFLER. Yes, sir.

Mr. KEITH. We are only talking about relatively small amounts it seems to me.

Mr. LOEFFLER. Yes, sir; that is very true. What we are talking about is—

Mr. KEITH. \$10 or \$15 perhaps per shareholder.

Mr. LOEFFLER. In our particular situation it is \$3 a thousand per shareholder.

Mr. KEITH. Yes. Now you used the word "mutual" whereas most of the funds are not really mutual in the same sense that a mutual life insurance company is.

Mr. LOEFFLER. Yes, sir; that is true.

Mr. KEITH. Did you start out being a mutual literally?

Mr. LOEFFLER. No, sir; a mutual fund is really a term which refers to the portfolio only.

Mr. KEITH. Right.

Mr. LOEFFLER. To the portfolio only.

Mr. KEITH. It is to the mutual interest of the portfolio shareholders and the management company shareholders to have a good return, but their interests are sometimes capable of separation.

Mr. LOEFFLER. Yes, sir.

Mr. KEITH. Is there any State that has a law speaking to the point of a business calling itself a mutual when it isn't a mutual, do you know?

Mr. LOEFFLER. Not that I know of, sir. Technically under the Investment Company Act these funds are open end investment companies.

Mr. KEITH. Yes.

Mr. LOEFFLER. Open end investment management companies I believe is the technical phrase, and the term "mutual fund" is just a term that has come along.

Mr. KEITH. You mentioned face amount certificates.

Mr. LOEFFLER. Yes, sir.

Mr. KEITH. Is this a product that is generally sold throughout the industry or are you one of the few that still does it?

Mr. LOEFFLER. No, sir. IDS sells, I guess, 95 percent or more of the face amount certificates. There are one or two other small face amount certificates companies, but principally it is an IDS product.

Mr. KEITH. And what volume of business do you do in face amount certificates?

Mr. LOEFFLER. I think currently ISA, the IDS certificate company, the face amount certificate company, which is Investors Syndicate of America, has about \$800 million in assets, something over \$2 billion in face amount certificates outstanding, and I think our sales currently of face amount certificates are running in the neighborhood of approximately \$160 million a year in face amount.

Mr. KEITH. Would you briefly describe to the committee what your face amount certificate approach is, and what the compensation is?

Mr. LOEFFLER. The face amount certificate is in effect an installment savings contract. A customer purchases a face amount certificate and he pays in so much a month. Upon maturity, he is guaranteed a fixed amount, and that is the reason it is called a face amount certificate. Its assets are virtually all invested in fixed income securities. It pays a guaranteed yield plus a supplemental yield in the discretion of the directors of the company. I would equate it, sir, in effect to the savings portion of an ordinary life insurance policy. That is really what it is.

Mr. KEITH. What about the compensation to the agent selling it?

Mr. LOEFFLER. To the sales representative who sells it? The compensation to the sales representatives who sell face amount certificates is, well, I started to say it was about akin to that of the sale of an ordinary life policy of the same amount. It is not. It is less than that, I believe.

Mr. KEITH. But the law is very specific, I believe, the law with reference to a face amount certificate load.

Mr. LOEFFLER. Yes, sir. There are provisions in the law, as it is today, which would allow the deduction of 50 percent of the first year's payments, which can be used then for commission to the sales representative. The IDS certificate, however, does not do that. It deducts 20 percent from the first year's payments rather than the 50 percent.

Mr. KEITH. Are they uniform payments over a period of years?

Mr. LOEFFLER. They are uniform over a period of either 15 years or 22 years.

Mr. KEITH. So what are your total commissions, generally speaking?

Mr. LOEFFLER. Well, let me say the amount deducted doesn't necessarily all go to commissions but covers the total costs. In the case of one certificate, that is the 15-year certificate, it comes to 5.69 percent. In the case of the 22-year certificate, it comes to 3.74 percent.

Mr. KEITH. One final question that I have at this time. Do you charge for the reinvestment of capital gains and/or dividends?

Mr. LOEFFLER. No, sir; IDS does not charge.

Mr. KEITH. I thank you, Mr. Chairman.

Mr. MOSS. Do you operate in California?

Mr. LOEFFLER. Yes, sir; we do.

Mr. MOSS. Are your salesmen successful out there?

Mr. LOEFFLER. I assume so, sir. Success is a relative term.

Mr. MOSS. How do their earnings compare with salesmen in the Nation generally?

Mr. LOEFFLER. I tried to get those figures before lunch, sir, but I didn't get them back in time. I would be happy to supply them to you, but I am afraid offhand I just don't know the answer.

Mr. MOSS. I think it would be very helpful to have them supplied for the record, and we will hold it at this point to receive them.

(The following letter was received by the committee:)

INVESTORS DIVERSIFIED SERVICES, INC.,
Minneapolis, Minn., November 7, 1967.

HON. JOHN E. MOSS,
Chairman of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, Rayburn House Office Building, Washington, D.C.

DEAR SIR: On the occasion of my testimony before your subcommittee on October 16, 1967, concerning H.R. 9510 and H.R. 9511, you asked that I supply certain additional information, first with respect to the earnings of our California sales representatives and district managers as compared to the earnings of our sales representatives and district managers throughout the country and, secondly, with respect to the earnings of our sales representatives relating these earnings to their length of service.

I am pleased to give you this information.

First with respect to the average gross income of our sales representatives and district managers throughout the country, my written statement contains the following figures:

AVERAGE GROSS INCOME FROM SALE OF ALL PRODUCTS

	Sales representatives ¹	District sales managers ²
1962	\$7,853	\$14,734
1963	7,571	13,683
1964	8,753	15,687
1965	9,159	16,767
1966	8,077	14,292
1967 (projected)	7,233	13,556

¹ Only representatives with more than 18 months of experience are included.

² Divisional sales managers—the next level of sales managers—usually have higher income than do district sales managers.

The comparable figures for our California representatives and district managers are as follows:

	Sales representatives	District sales managers
1962	(1)	\$20,024
1963	\$9,193	20,561
1964	9,027	16,752
1965	7,269	13,871
1966	6,112	
1967 ²		

¹ Not presently available.

² Projected.

Secondly, with respect to average earnings of our sales representatives and district managers by length of service, the figures are as follows:

AVERAGE EARNINGS, TOTAL SALES FORCE					
Service years	1962	1963	1964	1965	1966
0 to 1-----	(1)	(1)	(1)	(1)	(1)
1 to 2-----	\$6,264	\$6,103	\$7,323	\$7,353	\$6,290
2 to 3-----	6,936	6,938	7,784	8,435	7,167
3 to 5-----	7,976	7,615	9,593	10,033	8,742
5 to 10-----	9,082	8,939	10,866	12,139	10,788
Over 10-----	9,194	8,841	10,291	11,592	10,679

¹ Not available.

I hope this information is helpful to you and to your subcommittee and I want to assure you that if any further information would be helpful to you I would be pleased to try to supply it.

Sincerely yours,

ROBERT M. LOEFFLER,
Vice President-Law.

Mr. Moss. You indicate that the probable reduction in earnings of your salesmen would be to a figure of approximately \$5,200 if the recommendations of the—

Mr. LOEFFLER. Yes, sir; this is on the basis of 1966 figures.

Mr. Moss. And is this just a straight statistical study or do you make some assumptions as to what is going to happen in competition and its impact on you? What all goes into arriving at this \$5,200? It intrigues me.

Mr. LOEFFLER. This assumes that we had been able to make the same sales, which we in fact made during the calendar year 1966.

Mr. Moss. And it is just a simple statistical projection of the same number of sales at a lower return per sale.

Mr. LOEFFLER. Yes, sir.

Mr. Moss. That is all.

Mr. LOEFFLER. Yes, sir; that is what it was.

Mr. WATKINS. Mr. Chairman.

Mr. Moss. Mr. Watkins.

Mr. WATKINS. I wonder if you could refresh your memory? I don't know whether my homework is just exactly right. You testified before the Senate Banking and Currency Committee on the SEC bill that we have before us.

Mr. LOEFFLER. Yes, sir.

Mr. WATKINS. Do you recall or do you feel this way today or are these your remarks and do you still feel as you did then?

You said this:

I know of no statute in the history of the United States, absent wartime, which gave either a federal agency or a court the power to prescribe the price for a product or service in a competitive industry in accordance with whatever in its judgment it deems to be appropriate or reasonable.

Do you remember making those remarks?

Mr. LOEFFLER. Yes, sir; I made that statement.

Mr. WATKINS. Do you feel the same way now?

Mr. LOEFFLER. I feel exactly the same way now.

Mr. Moss. It is repeated on page 25.

Mr. WATKINS. I just wanted it clarified. I haven't read his whole report. I haven't read it at all, Mr. Chairman.

Mr. LOEFFLER. It is in my written statement.

Mr. WATKINS. I have been listening to the gentleman ever since he started. Thank you very much.

Mr. MOSS. Of course, we are going to do a little research job on that.

Mr. LOEFFLER. Yes, sir.

Mr. MOSS. And find out how good your recollection is.

Mr. LOEFFLER. I am sure you will. I think I should say, Mr. Chairman, that I made that statement first in January, saying, "so far as I can offhand think of." I had a lot of research done, and in February repeated the statement again in a public forum, in which I think I phrased it in terms of "so far as I have been able to discover," and by the time we got to the Senate committee, I think I was able to state it more flatly, as I did there.

Mr. WATKINS. Thank you very much.

Mr. LOEFFLER. It was not made without considerable research.

Mr. MOSS. The statement is made without any qualification, so just on its face it falls because we had the Civil Aeronautics Act of 1938. If you want to qualify it, why, then we can get into narrowing the field, we might have a different answer.

Mr. LOEFFLER. That is a franchised industry, sir.

Mr. MOSS. Well, is it franchised? It has some certifications.

Mr. LOEFFLER. Yes, sir; that is what I mean by franchised. It is regulated.

Mr. MOSS. In 1938, yes. In any event—

Mr. LOEFFLER. I am sure you will be doing your research.

Mr. MOSS. Absent the qualification or any further qualification you might like to make—

Mr. LOEFFLER. When I explained that I only wanted to convey that I did not make the statement lightly, having—

Mr. WATKINS. Don't back off. You did research on it.

Mr. MOSS. Is selling one of your responsibilities? You are vice president of—

Mr. LOEFFLER. No, sir. I am vice president—law.

Mr. MOSS. And so your evaluation of impact on sales represents the consensus within your company rather than—

Mr. LOEFFLER. Yes, sir.

Mr. MOSS (continuing). Rather than a conclusion arrived at from any personal experience.

Mr. LOEFFLER. Yes, sir; this is based really upon my conversations with those in the company and studies which they have made and which I have seen.

Mr. MOSS. I am in the process of trying to—

Mr. LOEFFLER. I am also a director.

Mr. MOSS (continuing). Of trying to get a study which I recall being made, which illustrates a very interesting phenomenon. That sometimes when sales commissions are high, the earnings per man tend to reduce, and that if you lower them a little, you sometimes increase the earnings per man. You retain the best producers.

Mr. WATKINS. Mr. Chairman, would you yield just a minute?

Mr. MOSS. Yes, I will be very happy to yield.

Mr. WATKINS. I am rather disturbed, Mr. Chairman, working on this figure that these people would make, that we are going to put a

lot of people on welfare if we pass this bill. In other words, they will get from welfare just about as much money as they would make.

Mr. MOSS. Let me say to the gentleman from Pennsylvania I am not quite as apprehensive as he is. I haven't the pessimism as to the capability of these people to go out and produce. I have worked around salesmen a long time. I have found that they are an amazingly resilient group, and the really able ones are going to make a living come hell or high water.

Mr. LOEFFLER. We just hope they will be able to continue—

Mr. MOSS. Even the SEC is not going to stop them.

Mr. LOEFFLER. We just hope they will be able to do it for us.

Mr. MOSS. I think they can.

Mr. WATKINS. I don't want to question the distinguished chairman, but how in the world can you say a man is making a living taking care of a family with \$5,200?

Mr. MOSS. Mr. Watkins, the Chair is attempting—

Mr. WATKINS. California is much better than down my way. You can't do it.

Mr. MOSS (continuing). The Chair is just attempting to point out the fact that the figure of \$5,200 for the purposes of this committee or for the purposes of any objective analysis of the impact of this legislation is a meaningless figure. That it is more charitably described as an exercise in statistics, and that is all it is.

Mr. WATKINS. In other words, there is another way of making money.

Mr. MOSS. It represents no other value judgments, no element of experience, nor anything else as a basis for projecting the \$5,200.

Mr. LOEFFLER. I don't think it was that cold a statistic, sir.

Mr. MOSS. You just take a number of sales in 1966, and if we were to pay at a lower rate of commission just on those sales to the same sales force, that the same general incentive and the same type of direction, that this is what it would produce.

Mr. LOEFFLER. It was the judgment of those in our sales department, sir, that a reduction would not have had an offsetting increase in volume of sales.

Mr. MOSS. But that isn't always necessarily true.

Mr. LOEFFLER. This is the judgment factor. I realize that, sir.

Mr. MOSS. We can go to many of our regulated industries, where we have heard the direst of predictions of the pattern of earnings in the event of certain reductions, and amazingly we have witnessed a spurt in growth and earnings following the reductions. Now, I don't say that this is normal in selling, but I say that you cannot safely make these assumptions you have made without going beyond just the figures of 1966 and the impact of a new standard on 1967 or 1968.

Mr. LOEFFLER. We are subject necessarily to what happens in the general economy.

Mr. MOSS. Well, you are also subject to what happens in competition, you are also subject to what happens in motivation of the salesman and the quality of salesmen.

Mr. LOEFFLER. Yes, sir; we would not disagree with that.

Mr. MOSS. What is the rate of turnover of your sales force?

Mr. LOEFFLER. The turnover of our salesmen in the initial year, that is those who have just been validated and are in their first year, after

the end of 1 year we would have 70 percent of those. After the sales representative has remained with IDS for a couple of years, has decided for himself as well as for the company that this is the career he wishes to pursue, then our turnover drops off to less than 10 percent.

Mr. Moss. You have 10 percent after the second year, is that correct?

Mr. LOEFFLER. No, sir.

Mr. Moss. You said after the first year you lose 30 percent.

Mr. LOEFFLER. Yes, sir, and then we lose another 25 percent of the remaining 70 percent during the second year.

Mr. Moss. So you lose 25 percent of the 70 percent.

Mr. LOEFFLER. Of the 70 percent during the second year.

Mr. Moss. In the second year.

Mr. LOEFFLER. Yes, sir, and then that is generally the end of it.

Mr. Moss. Or roughly about 16 percent or 15 percent.

Mr. LOEFFLER. Something like that. Then after—

Mr. Moss. So you lose about half in the first 2 years.

Mr. LOEFFLER. Yes, sir.

Mr. Moss. And from there on you say your rate is about 10 percent a year.

Mr. LOEFFLER. No.

Mr. Moss. Of that half.

Mr. LOEFFLER. It is less than that, sir.

Mr. Moss. Less than that. The figure of 10 was yours, not mine.

Mr. LOEFFLER. I think I said less than 10 percent. I meant to say less than 10 percent, sir.

Mr. Moss. So you have a fairly good turnover in your in-and-outers.

Mr. LOEFFLER. No, sir; I wouldn't call them in-and-outers. They never come back.

Mr. Moss. Let's say the hoped—

Mr. WATKINS. He is trying to break you down. He is clever.

Mr. LOEFFLER. I understand.

Mr. Moss. These are the young hopefuls. Now are they considered, their earnings in the average which you cited for us?

Mr. LOEFFLER. We did not take into the averages which I cited the income of any sales representatives who had been with the company less than 18 months.

Mr. Moss. You took none of the less than 18 months.

Mr. LOEFFLER. No, sir.

Mr. Moss. All right, when does this last 25 percent occur, how much of it in the last 6 months of this 24-month period?

Mr. LOEFFLER. I don't think I could answer.

Mr. Moss. You see, if we are going to use statistics here, I want to use them rather precisely.

Mr. LOEFFLER. We tried to make them meaningful, sir. That was the reason we left out these first 18 months.

Mr. Moss. Yes, I appreciate that.

Mr. LOEFFLER. We subsidize the first ones. We also have a pension program for our sales representatives.

Mr. Moss. And now from the second year to the third year and the fourth year, what is the rate of progression on earnings? Do they continue to show improvement in producing?

Mr. LOEFFLER. Generally speaking, they do, yes, sir.

Mr. MOSS. They don't just reach a plateau and stay there.

Mr. LOEFFLER. Well, at some point.

Mr. MOSS. When you lose 10 percent do you because they get better opportunities?

Mr. LOEFFLER. Usually because they have better opportunities.

Mr. MOSS. Or because some of them stop producing?

Mr. LOEFFLER. Some retire and some get better opportunities. Some are sought by competition. If you would like, I have some figures here on that, sir.

Mr. MOSS. I think it would be very helpful.

Mr. LOEFFLER. Yes, sir.

Mr. MOSS. I don't think it is necessary to take the time now. If you will just simply supply them to us for the record.

Mr. LOEFFLER. All right, I can do it very briefly. Of the sales representatives who have been with the company from 1 to 2 years, the average earnings—this is 1965—was \$7,300; 2 to 3 years, it went up to \$8,400; 3 to 5 years, up to \$10,000; 5 to 10 years, up to \$12,000; and then over 10 years the average is \$11,500. If you would like, I can supply these in writing.

Mr. MOSS. I think it would be helpful to supply them for the record. (See letter dated November 7, 1967, on page 490.)

Mr. MOSS. I think that is all I have at this time. I want to express on behalf of the committee our appreciation for your appearance here. It has been very helpful to us, and I assure you that your views will be very carefully considered.

Mr. WATKINS. I join with my chairman in those remarks. Thank you for being so courteous.

Mr. LOEFFLER. Thank you, sir.

Mr. MOSS. Now we have Mr. Fred M. Alger, president of Fred Alger & Co., Inc.

STATEMENT OF FRED M. ALGER, PRESIDENT, FRED ALGER & CO., INC.

Mr. ALGER. Mr. Chairman, members of the subcommittee, I am Fred M. Alger, president of Fred Alger & Co., Inc., a nonregistered institutional investment adviser. Thank you for granting me the honor and privilege of this opportunity to appear before you to express my thoughts on the proposed amendments to the Investment Act of 1940 and the Investment Advisors Act of 1940, numbered H.R. 9510 and H.R. 9511.

My company renders investment advice to corporations and individuals. One of our clients is Security Management Co., Inc., a Kansas-based management company which manages two funds, the Security Equity Fund, Inc., and the Security Investment Fund, Inc. Both funds are corporations registered as open-end investment companies pursuant to the Investment Act of 1940.

Since we began advising the Security Management Co., in January of 1965, the Security Equity Fund, which is a growth fund, has had the best cumulative investment performance of all mutual funds in the United States, recording a gain of 200 percent, more than 10 times that of the Dow Jones industrial average during the same period.

In January of 1965, when we first began managing it, the Security Equity Fund had net assets of \$400,000 and today, 3 years later, it has net assets of \$60 million. The growth of this fund results from both increased sales and performance. The shares of the fund are solely marketed by independent broker-dealers who, based upon our performance, have decided to sell our shares.

Mr. Chairman, in the interest of conserving the committee's time, I would like to request that my statement be made a part of the record of this hearing and that I be permitted briefly to summarize my position.

Mr. Moss. If there is no objection, the statement will be included in the record at this point and we will be pleased to hear your summary.

Is there objection? Hearing none, the statement is accepted for the record.

Mr. ALGER. Thank you.

(Mr. Alger's prepared statement follows:)

STATEMENT OF FRED M. ALGER, PRESIDENT, FRED ALGER & CO., INC.

Mr. Chairman, members of the subcommittee, I am Fred M. Alger, President of Fred Alger & Company, Inc., a non-registered institutional investment adviser. Thank you for granting me the honor and privilege of this opportunity to appear before you to express my thoughts on the proposed amendments to the Investment Act of 1940 and the Investment Advisers' Act of 1940, numbered HR-9510 and HR-9511.

My company renders investment advice to corporations and individuals. One of our clients is Security Management Company, Inc., a Kansas-based management company which manages two funds, the Security Equity Fund, Inc., and the Security Investment Fund, Inc. Both funds are corporations registered as open-end investment companies pursuant to the Investment Act of 1940.

Since we began advising the Security Management Company in January of 1965, the Security Equity Fund, which is a growth fund, has had the best average growth performance of all mutual funds in the United States. In January of 1965, when we first began managing it, the Security Equity Fund had net assets of \$400,000 and today, three years later, it has net assets of \$60 million. The growth of this fund results from both increased sales and performance. The shares of the fund are solely marketed by independent broker-dealers who, based upon our performance, have decided to sell our shares.

I wish to address myself to Sections 8, 12 and 25 of HR-9510. First I will address myself to Section 12 of the Bill, which is the proposal to limit the sales charge on the sale of mutual fund securities to 5%.

This reduction in the sales charge, in our opinion, would virtually put all independent broker-dealers out of business. It would render it impossible for Security Equity Fund to successfully market its shares. It will do so because it will reduce the commissions paid to the independent broker-dealers to a level where they can no longer afford to sell our shares.

The present average sales charge on the sale of a mutual fund share is 8.5%. This 8.5% charge is normally divided as follows: 2% goes to the underwriter for printing and distribution costs, but the SEC has conceded that, even at this rate, underwriters generally lose money on the distribution of shares. Another 2% goes to the independent broker-dealer who maintains an office and place of business out of which his salesmen operate. The SEC did not evaluate the costs of the independent broker-dealers, but from my conversations with numerous representatives of broker-dealers I can state that their profit is generally marginal. The remaining 4.5% goes to the salesman who actually sells the mutual fund share. Mr. Robert M. Gardner, former president pro-tem of the NASD, pointed out at the Senate hearings on this same subject that, based on the present rate of commission, four out of five salesmen average less than \$10,000 income per year. It is apparent that the cost of the underwriter in distributing the shares, and the cost of the broker-dealer will necessarily remain relatively constant. Therefore, if you allow the sales charge load to be reduced to a maximum limit of 5%, there will be less than 1.5% available to pay the salesman for his efforts, certainly not enough for him to remain in business.

I am frequently called upon to speak with the representatives of independent broker-dealers. They have all told me that if the sales charge is reduced to 5%, they will not be able to sell the shares of either Security Equity Fund, Inc., or other small or medium-sized funds, but will be forced to go out of business or seek employment as part of the captive sales force of one of the few very large mutual funds that may survive with a 5% sales charge. Thus, a reduction in the sales charge will immediately cause a reduction in the number of independent broker-dealers available to sell the securities of small and medium-sized aggressively managed funds, such as Security Equity Fund.

The independent broker-dealer is just what the name implies. He may, based upon the wants of his clients and the performance of the various funds, choose, with relative freedom, the funds which he wishes to sell. Generally, there are three types of mutual funds offered: A growth fund, such as Security Equity, which has, as its primary objective, capital gains; an income fund, which has as its primary objective the production of income, and a balanced fund, which strikes a balance between the production of income and capital gains.

A mutual fund is one of the few products which can prove its superiority statistically. There are several surveys which show which funds in each category have the best 1, 3, 5 or 10-year record. Therefore, the independent broker-dealer by referring to these services, can readily determine which are the best performing funds. It is obvious that the best performing funds are usually the easiest to sell. However, a salesman will not sell a fund, in spite of its performance record, if he is not adequately paid for his effort.

By reducing the sales charge to a 5% ceiling, you will bring about a reduction in the number of independent broker-dealers and a resultant lessening of competition within the mutual fund industry. The lessening of competition will occur because many aggressively managed and well-performing funds will go out of business because they can no longer afford the costs of marketing their shares.

As an example, in January of 1965, when we began to render financial advice to the management company of Security Equity Fund, Inc., it had net assets of only \$400,000, and was not able to afford its own sales force. Therefore, in order to market its securities it relied upon the services of independent broker-dealers. Today, three years later, the Security Equity Fund has capital assets in excess of \$60 million. The growth of Security Equity Fund has resulted from, first, the willingness of the independent broker-dealers to sell our shares, and, second, the outstanding performance of the fund. The fund has had the cumulative average growth performance record in the mutual fund industry over the past three years. Security Equity has proved to be a superior product but this security could not have been offered for sale to the public if it had not been permitted to levy the 8.5% sales charge. If three years ago there had been a limit of 5% sales charge, there would be no Security Equity Fund, Inc., and the public would have been deprived of the opportunity to purchase the mutual fund that has had the cumulative average growth performance record in the United States over the past three years.

The only funds that the public would have had offered to them would have been those funds which were sufficiently large to afford the luxury of a captive sales force. The salesman who is a member of a captive sales force sells only one product. The salesman will sell that product without regard for its performance. There is no incentive to this salesman to review the statistical records of various mutual funds and, based upon their respective investment goals, i.e., growth, balance, or income, sell that fund which has the best performance record. He is just what the name implies—a captive—and, as a captive, he is going to present only one point of view. This is not in the best interest of the purchasing public. The independent broker-dealer prefers to sell that product which has the best performance record.

It is the independent broker-dealer who rewards competitive investment performance by exposing the public to a better product. The incentive is a natural one. A better product is easier to sell and results in a satisfied customer. A salesman who is a member of a captive sales force sells only one product and you can be certain that if his is not the best product, he will not bring that to the attention of the potential buyer.

If you reduce the sales charge load to 5%, you will put the independent broker-dealer out of business and thereby eliminate small, aggressively managed mutual funds.

Next, I would like to address myself to SEC's proposals in Sections 8 and 25, that further regulations be imposed upon the fees charged by investment advisers. The SEC claims that management fees are excessively high and proposes that the Act be amended to provide that an investment adviser may be sued for the return of his fee if it is "unreasonable". The essence of the SEC criticism is that a management company will charge a mutual fund 0.5% annually for the management of the fund while a private account of the same amount will pay considerably less for comparable service.

It is unfair and misleading to compare the fees charged by a mutual fund management company with those of banks, trust companies and similar institutions. The quality and degree of service rendered are essentially dissimilar. While the fiduciary institutions give, at best, monthly supervision to their accounts, a firm of our size gives close attention on a daily basis. Further, the institution can allocate its cost of supervision over the entire spectrum of their operations and need not support this fiduciary function solely by income derived from their advisory services. In addition, there are corollary benefits that they derive from handling said funds.

Our firm charges, for the management of private accounts, 1% of average assets per year, or 10% of total appreciation during the same period of time, whichever sum is greater. Our firm purposely has injected an incentive feature to encourage us to actively and diligently manage our portfolios. We have one security analyst for every three and one-third portfolios. We review the securities in every portfolio every day. In fact, we conduct an hour-by-hour review of market conditions and the market price of each and every security which we hold. Thus, in our opinion, when the SEC compares fees of mutual fund management companies to some large private accounts it is not referring to fully managed high-performance accounts. Rather, it is referring to those accounts which are relatively inert, not fully managed—in our sense of management—and not competitive. There is published almost daily in newspapers a comparison of the performances of publicly held mutual funds. This places a burden on the management company which does not exist for banks, trust companies and other private managers, whose performance records are rarely, if ever, a matter of public record or interest.

The provisions of the Investment Company Act of 1940 provide that the shareholders of a mutual fund must approve the contract with the management company. Therefore, there is full disclosure, and the shareholders are fully aware of the terms and conditions of the contract. I do not believe that management companies make an excessive profit. As a comparison, the eighth largest advertising company, a service organization, last year made a larger profit than the second largest mutual fund management company in the United States.

The SEC further wishes to amend the definition of investment advisors to prevent firms such as ours being paid on the basis of an incentive fee contract, yet the SEC admits that performance should be a factor in determining fees, when it states on page 145 of its report, and I quote: "The sustained investment performance of a company would be an appropriate consideration in evaluating the reasonableness of its advisor's compensation." We use incentive fee contracts for some of our private portfolios. Our contract is designed to reward us in proportion to how well we perform for our client in relation to what he might have made, had his money been unmanaged. The incentive feature of a contract goes to the very essence of why an individual hires someone to manage his portfolio. The SEC, on page 73 of its report, attempts to justify its opposition to percentage fees and incentive contracts, and I quote: "Management fees based on a percentage of assets tend to avoid conventional limitations on executive salaries." This statement is misleading for we all know that today top management personnel are not limited to salary and are granted stock options, the value of which is clearly tied to performance.

Our firm is hired for the specific purpose of increasing the value of its client's portfolio. Why not encourage it to do so by permitting it to share in its growth? Our firm cannot hope to benefit from an incentive contract unless it, in fact, benefits its client. Incentive fees put a premium on performance and doing the best job possible for the client. Set fees will tend to put a premium only on holding on to an account and not performing so poorly as to lose it. Incentive fee contracts are fully consistent with the spirit of American business and government, which rewards an individual for excellence in performance.

In closing, I wish to state that in my opinion the Investment Act of 1940 and the Investment Advisors' Act of 1940 provide more than adequate protection

to the individual investor. The Acts provide for full disclosure by the mutual fund company. A mutual fund company produces a product—its shares—and offers them for sale to the public. The public purchases the shares for one of three purposes—growth, income, or a balance between growth and income. The SEC has refused to accept that a mutual fund share is a product, because it says if it did so its entire report is without meaning. To quote the SEC: "Some . . . suggest that any conflicts that may exist between the interest of the fund managers and underwriters and those of their customers—the mutual fund investors—are no different from the usual conflicts of interest between buyers and sellers . . . (that) the fund . . . has little . . . independent significance for it is essentially the brand name under which a particular investment advisor sells its services to the public . . . If this view were accepted, the questions raised . . . by the special study . . . might be of little significance. The Commission believes it would be most unwise to accept the foregoing analysis for regulatory purposes." (Pages 75 and 76 of their Report).

I believe that a mutual fund share is a product which is offered for sale by a mutual fund company in a highly competitive market. The buyer has the opportunity to select from a large number of products. The full disclosure provisions of present legislation more than adequately protect the prospective buyer. In addition, the NASD with Congressional approval, presently regulates the marketing practices of mutual funds, underwriters, independent broker-dealers and their salesmen. I believe that the NASD and the industry should be permitted to develop new marketing practices and self-regulation. We have just submitted a new concept for marketing mutual funds securities to the NASD. We believe our proposals will be highly beneficial to the customer, broker, salesman and underwriter. Because our plan will provide security and other benefits to the salesman and the broker-dealer, it will ultimately permit the reduction of the sales charge from 8.5% to 6.5%. This plan is non-exclusive and because of the benefits to all concerned, we believe it will ultimately be copied throughout the industry.

I believe industry and the NASD should be free from legislative restrictions on price and cost schedules to implement new innovations within the industry when and if they become feasible.

Thank you, Mr. Chairman. This concludes my prepared remarks and I would be glad to answer any questions that you or the Committee members may wish to ask.

RÉSUMÉ OF FRED M. ALGER

Fred M. Alger, born Detroit, Michigan, 1934. Bachelor of Arts Degree, Yale University (June 1956), Master of Business Administration Degree, University of Michigan (June 1958). 1957 and 1958 Security Analyst at First of Michigan Corporation; 1958-1959 Security Analyst at Wells Fargo Bank; 1960-1961 Security Analyst at North American Securities Company; 1961-1964 Portfolio Manager at Winfield & Co., Inc.; 1964 Founder and President of Fred Alger & Company and Falco Associates. Fred Alger is on the Board of Fred Alger & Company, Inc., Falco Associates, Inc., W. A. Benjamin, Inc., Publishers, H. C. Bohack & Co., Inc., a New York Grocery Chain, and Security Investment Fund.

Fred Alger & Company was retained as Research Consultant to Security Management Company on January 1, 1965. At that time, Security Management Company was the investment adviser to the Security Equity Fund, a growth fund with assets of \$400 thousand, and Security Investment Fund, a balanced income fund of \$8 million. Since that date Security Equity Fund has had the industry's best investment results recording a gain of 200%, ten times that of the Dow Jones Industrial Average, and has grown in size to over \$60 million. The Security Investment Fund, during the same time period, has had the best cumulative investment record of balanced funds concentrating on income and has grown to \$11.5 million.

Mr. Alger's firms, Fred Alger & Company, Inc., and Falco Associates, Inc., also run the portfolios of several large clients, including a large segment of the FOF Proprietary Funds, Ltd., which is wholly owned by The Fund of Funds, Ltd.

Mr. ALGER. First, mutual funds fall into three product categories: Growth funds, income funds, and balanced funds. A mutual fund share

is a product that is offered to the public, with full disclosure for sale in a highly competitive industry. As a product, a mutual fund is one of the few products which can prove its excellence statistically. For example, I can prove that the security equity fund, which portfolio we run, has the best performance record in the industry during the 3 years we have managed it. This is not true of most products offered for sale. For example, can Chevy prove its excellence over Ford?

The independent broker-dealer chooses which product he wishes to sell. The independent dealer is important because he rewards excellence by selling the best product the industry has to offer. At the other extreme, a captive sales force sells whatever its management company offers.

For example, reading the testimony of Mr. Loeffler who preceded me, page 6, he says at the bottom talking about IDS's captive sales force, he says:

However, the only products sold by IDS * * * are the shares of the IDS-managed funds.

Very simply, if the 5 percent load goes through, in order to maintain his income, the independent dealer will be forced to affiliate with one of the few surviving larger mutual funds with a captives sales force. Small funds, such as our own, will not be able to afford to distribute product. The market will be abandoned to the multibillion dollar behemoths of the industry.

Second, H.R. 9510 proposes to amend section 203(b) and 205(1) so that any investment adviser to any investment company must register with the SEC—and by so doing, it cannot charge a fee based on performance. As I told you, we run the portfolios of two registered investment companies. We also have about 10 clients whose private portfolios we run. We charge a clients' fee of 1 percent of average assets or 10 percent of total appreciation, whichever is greater. We qualify for the performance fee if we beat the market by a certain percentage.

We do not solicit accounts. We do not hold ourselves out to the public generally. Individuals or corporations who have noticed the fund's performance seek us out and ask us to manage money for them, despite the fact that our fee schedule is substantially above that charged by the funds we run.

The SEC's rationale is to "insulate investment company shareholders from arrangements that give investment managers a direct pecuniary interest in pursuing high risk investment policies."

What do you say to something which just is not true?

On the one hand my firm's name—our pride of craft—is intimately involved with the public record we show for the funds. On the other hand, individual clients are charged fees which relate directly to their performance in the market.

A reputation of honesty and excellence cannot be bought. I have built my company on these contracts and on my name. I resent any meretricious implication which would cause legislation to put me out of business. Accordingly, I urge you to scrap the relevant amendments in sections 203(b) and 205(1).

Third, I have noted in reading the accounts of these procedures that the committee is interested in receiving specific proposals from the industry.

The principle of self-regulation has worked remarkably well, as the SEC point out. I believe the regulatory role of the NASD should be strengthened vis-a-vis the members. At the same time, however, Congress should make the NASD structurally more responsive to its membership by allowing immediate judicial review of administrative decisions before disciplinary action has been enforced. For instance, we have recently submitted to the NASD a new concept for marketing mutual funds. It will involve a cut in the load from 8.5 percent to 6.5 percent and, at the same time, strengthen the economics—and this is very important—for the independent dealer and his salesmen. This plan is nonexclusive and because of the benefits to all involved, we believe it will be copied throughout the industry.

As you know, the NASD's administrative authority to approve or disapprove this plan is absolute and final. If it does not approve the plan, its judgment cannot be tested in court unless the NASD puts us out of business for doing it any way. It is a high price to pay to prove a point.

At the present time, as only the very large funds or their closely affiliated dealers have the manpower and the money to afford the time to serve on the NASD's key committees, and specifically the investment companies committee, I believe the decisions of the investment companies committee and the NASD may reflect the interest of the very large mutual funds and not necessarily the best interests of the industry as a whole.

I suggest to you that whatever problems the industry might have would be solved very simply by natural competitive forces if administrative decisions by the NASD were immediately subject to some independent, disinterested judgment.

Thank you, Mr. Chairman and members of the subcommittee.

Mr. Moss. Mr. Watkins?

Mr. WATKINS. No questions.

Mr. Moss. I find your statement on page 4, item 3, most interesting, because it acquaints me with a broad new authority in the hands of the NASD that I was not previously aware of, and I think one might be highly illuminating to the SEC because we have had some discussions as to whether or not we should turn this regulatory function over to the NASD. I think it was the subject of the exchange of letters between Senator Sparkman and the then chairman or president of NASD.

Mr. ALGER. I think it is a very subtle thing.

If you will, Mr. Chairman—

Mr. Moss. I would like to have the subtlety made a little more apparent.

Mr. ALGER. Well, we feel, I feel, that the NASD, as the SEC has pointed out, has done a very good job over the years. Practically speaking, the investment companies committee has a great deal to do with, in fact controls, the marketing structure of the mutual fund industry. It is represented only by members of large, gigantic funds and their interests.

Our suggestion is that if the investment companies committee or rulings by the NASD could be made subject to judicial review without having to go out of business—no one wants to do this to prove

a point—but if they could pass down a decision, and then if the member wanted, direct it to some independent judicial authority for review as with regard to their own standards or to the law which they interpret, then I think you would see unleashed vast new competitive forces. I mentioned this plan which we have. We can economically keep the independent broker-dealer in business and at the same time cut the load.

Mr. MOSS. We would be of course most interested, I assure you, in the proposal that you have to cut the load from eight and a half to six and a half, because that is one of the things that this series of hearings is about, but the authority that you ascribe to the NASD in this particular area of activity I do not think exists.

Mr. ALGER. You are wrong, Mr. Chairman.

Mr. MOSS. My counsel advises me that I am not.

Mr. ALGER. I think your counsel is wrong.

Practically speaking, you have to go to the NASD first to make any change. I am not talking about just cutting the load. We are talking about an overall plan, a new way of compensation.

Mr. MOSS. I think that a new way of compensation would probably have to come here, would it not?

Mr. ALGER. No, no.

Mr. MOSS. To the extent that you are discussing it in this context.

Mr. KEITH. Mr. Chairman, the area in which I think the disagreement exists is as to the judicial review. The NASD could prescribe a lower commission schedule, as long as it was within the scope of the—

Mr. ALGER. Oh, now. We could, for instance, cut the load. I mean we could independently cut, instead of saying eight and a half, cut it down to six and a half or two or anything. We could do that.

Mr. KEITH. Who is "we"?

Mr. ALGER. I am talking of the Security Management Co.

Mr. KEITH. Your firm could do it.

Mr. ALGER. Well, the Security Management Co. We advise them on how to run portfolios.

Mr. MOSS. Yes.

Mr. ALGER. But the Security Management Co. could, or anybody could who is a member of the industry. You can cut the load. However, if it involves a restructuring of the meaning of discounts and concessions—I will tell you exactly what we were going to do. We were going to set up—are you acquainted with pension funds?

We were going to set up a pension fund for the salesmen of independent broker-dealers, which would have full vesting after 5 years, no vesting before 5 years, but full vesting at the end of the fifth year. Further, we would do this via a closed-end mutual fund, which would have 400 shares or a per share value of \$250.

Now in return for a sustained commitment by the independent broker-dealer to sell our shares, we would agree that to the extent the performance of the fund fell below a certain performance level, we would contribute into the fund from the management company fees which his sales would represent, so basically we would be running a pension fund for his salesmen.

Now this would all be fully disclosed in the prospectus. We were going to cut the load, and also we were going to spell out the details of

this proposed pension fund as a part of the prospectus. Now to do this we have to go to the NASD to get their approval before we can put such a program into effect. And while we have not received formal—

Mr. KEITH. Not so much because of its unique nature, although I assume that is one thing they are bound to look at critically?

Mr. ALGER. It is just that they have control in this area. This is why you have had no change in the marketing structure of mutual funds in the last 25 years.

Mr. KEITH. Just because they did not like your particular way?

Mr. ALGER. Not just mine.

Mr. KEITH. Of establishing the pension funds?

Mr. ALGER. Not just mine.

You would think in such a highly competitive industry, with over 100 managements actively competing for the investor's dollar, that someone would have come up with something different. Everyone has got very fertile minds, but their ideas have been nipped in the bud at the Investment Companies Committee of the NASD.

Mr. KEITH. Mr. Chairman, I would like to ask some other questions.

Mr. MOSS. Certainly.

Mr. KEITH. Are you one of the chief advisers to those in charge of the portfolio of Security Equity Fund?

Mr. ALGER. Yes. We run the portfolio.

Mr. KEITH. What is your relationship? You are the president of the firm that runs the portfolio?

Mr. ALGER. That is correct.

Mr. KEITH. Do you consider yourself a performance fund?

Mr. ALGER. Fully managed. We are a performance fund, fully managed though.

Mr. KEITH. What do you mean by "fully managed"?

Mr. ALGER. Well, I think there is a difference. If I were talking in the industry I would say performance. Outside the industry I would say fully managed, because, for instance, when the SEC is talking about "insulating investment company shareholders," they mention words like "high risk" or "performance," and there is an implication here that it is a kind of rolling dice, and that is not necessarily true.

For instance, rolling dice would probably have implications relating to the sort of stock we would be investing in, an implication extending a little bit further that he would be investing in unseasoned stocks, small capitalizations or something along these lines.

Just to give you an idea of what I mean by fully managed as compared to this orientation. For instance, last year if we had been investing in blue-chip stocks we probably would have done as badly as the market did, which was down 16 percent. In fact, every single one of our accounts was up.

Mr. KEITH. By fully managed, do you perhaps mean that because it is a relatively small fund, you are right with it all the time, and you do not buy for the long trend; you buy what in your view is going to move in the right direction in the next few months as contrasted to buying the true blue chips? Is that what you mean by fully managed?

Mr. ALGER. Well, I mean our minute-by-minute management, trying to get a mix, a broad mix in the fund which performs well as compared with other funds. Now, you cannot go hog wild on this.

For instance, there is a Treasury ruling, just to give you an idea—you were talking about a few months—there is a Treasury ruling which has been in effect that to stay an investment company and still retain the tax benefits, you cannot have more than 30 percent of your gross income coming from short-term profits; not net short-term profits but total short-term profits within a 90-day period. So when we are talking about fully managed, we are not talking about really just staying in for a few weeks or a few months. You really have to stay in for 6 months or more.

Mr. KEITH. How much turnover was there in your portfolio in the last fiscal year?

Mr. ALGER. Substantial. It was certainly over 100 percent.

Mr. KEITH. You have a portfolio currently in the vicinity of \$60 million?

Mr. ALGER. You see it has grown. The assets have grown so quickly.

Mr. KEITH. I understand that. I would expect them to grow, particularly with the kind of management that you have been stressing.

Now what is the average length of time that you hold a stock in your portfolio?

Mr. ALGER. As long as possible.

Mr. KEITH. As long as you expect it to improve relatively well as contrasted with other improvements in the market?

Mr. ALGER. That is right.

Mr. KEITH. How long does that usually last?

Mr. ALGER. There is no usual. There is no way of defining this. I am not trying to avoid you.

Mr. KEITH. Let's do it mathematically.

What was the total volume of sales last year in your fund?

Mr. ALGER. Eleven million approximately.

Mr. KEITH. Of a \$60 million portfolio, you only sold—

Mr. ALGER. We started out at \$400,000, and then it moved up to \$2 million at the end of the first year and then \$11 million at the end of the second year in sales, and this year we have gotten \$40 million approximately.

Mr. KEITH. In sales?

Mr. ALGER. Yes.

Mr. KEITH. This year you have had \$40 million in sales?

Mr. ALGER. Thirty million.

Mr. KEITH. That means new capital that has come in?

Mr. ALGER. That is correct.

Mr. KEITH. And how well have you done with that new capital? What would this book here say with reference to your success?

Mr. ALGER. Is that Weisenberger?

Mr. KEITH. Yes.

Mr. ALGER. We are probably not in Weisenberger. We may very well be in it, I do not know but they have size limitations. We may very well be in it. I think maybe we did qualify. We are up about 55 percent this year. We are running about tenth in the industry. The year before that we were second. The year before that we were first on performance.

It is awfully hard, I mean—

Mr. KEITH. Were you here when we had the discussion concerning possible speculation in the market, not in the informed sense of the word but the rolling of dice to which you referred?

Mr. ALGER. You see this just does not exist. It exists somewhere. I mean it is something which seems to have caught on.

For instance, I am just trying to point out, last year if we had owned the big companies, we would have lost a lot of money. We did not own them. We had cash at the right time and the companies we did own were growth stocks. This year growth stocks have been wonderful, but in the past 6 weeks we have been moving out of growth stocks into cash and into more traditional kinds of companies, companies which represent more nearly the economy. I think we just basically feel that growth stocks have had it.

But when you talk about speculation, last year I would have been speculating badly to have owned General Motors and not speculating very much if I had owned say Polaroid or something like that. We are not putting labels on stocks. It is a question of whether they are going to make money for you or not, the texture of markets change.

Mr. KEITH. What is the relationship of your board of directors with that of the mutual funds whose portfolio you advise?

Mr. ALGER. Well, in the biography at the very back it has me on the board of Security Investment Fund. That is a misprint. Actually, I recently went on the board of Security Management Co. I am not on the board of Security Investment Fund, which is a balanced income fund we also run.

Mr. KEITH. You said "we also run." You did not say "we also advise." That gets to a point that I have been trying to make throughout these hearings, that to all intents and purposes the funds are run by the companies and not advised by them, and that is what you said just now.

Mr. ALGER. Well, we run the portfolios, yes. There is no question about that.

Mr. KEITH. I realize that you manage the portfolio, but you said "run the fund."

Mr. ALGER. You know there is a problem in all of these discussions about arm's length or running the fund.

For instance, if a mutual fund did not allow a vote to its shareholders at all, we probably would not be having these discussions at all. If it were just treated like a stock insurance policy which you were to own, and you could also buy the stock in the insurance company, there would be no problem. I mean it is a product. If we just did away with the vote for the shareholder, there really would be no problem. It is a product which we run, that is right. It is a very competitive one. The rewards are tremendous, because if we do well, as you can see, it will grow from \$400,000 to \$60 million.

We do not have a captive sales force, but the independent broker-dealers will pick it up and sell it, because it is a good product and it is easy to sell, and we can prove it is a good product.

Mr. KEITH. Do you believe that there is the usual relationship between stockholder and management in mutual funds?

Mr. ALGER. Sure. It is just like any other company. Stockholders do not run the management of any company in the United States of any size practically.

Mr. KEITH. But the board of directors in the average corporation, when they are dealing with a service or a product which they are

buying, and a member of the board of directors has an interest, he has to stand up pretty straight to disclose the nature of the transaction in which he is involved.

Mr. ALGER. Well, of course in the same way, for instance, at our firm we have a last in, last out rule on investing in stocks. If everybody is completely in we can buy stock; all of our clients when I say everybody. And after everybody is out we can sell stock.

Mr. KEITH. Let's put it this way. In the board of directors of a mutual fund there are 40 percent that are unaffiliated.

Mr. ALGER. I think so.

Mr. KEITH. Therefore, there are 60 percent, generally speaking, that are affiliated. These people owe their allegiance to the management company, and they are disqualified from voting on the management contract, but they are nevertheless present during the discussions and they are very much involved in the decisionmaking process indirectly, and that is their primary responsibility. Therefore, the contract that is entered into is, generally speaking, not as arm's length as would be the case in other corporate transactions, I would think.

Mr. ALGER. Well, if we could—

Mr. KEITH. It gets back to what you just said, "We run the fund."

Mr. ALGER. We view it as a product which we are just trying to—

Mr. KEITH. Yes.

Mr. ALGER. I mean that is the way we view it.

Mr. KEITH. The SEC does not think this is healthy.

Mr. ALGER. Well, there is such tremendous competition. How can something be unhealthy which is so tremendously competitive? I mean that is of course the question, and in fact the SEC admits that if you view it as a product, the basis of the whole study does not exist. They admit this. And we say, "Well, gee, what else is it?"

I mean you can only describe it in competitive terms. They talk about the vigorous sales competition. They also make references to the entrepreneurial risk. There is no clear-cut guarantee to success in this thing.

In fact, I can tell you here we have had, and I will say the Security Management Co. has had the best product in the country, and once again here is a point which you can prove. You know, we can say we have had the best. We can prove it. And even so, just this year it broke even, and it has \$70 million in total assets under management. Just this year it broke even and there was great rejoicing. I mean no one is making an awful lot of money.

I have on my desk, for instance, in my office, an offer from a man who owns 40 percent of a company which is quite well known. They have about a half-billion dollars in assets under management which includes investment counseling accounts and some funds and they have a contractual program of \$150 million in face and they have a captive sales force and they have been making money every year, and what do you suppose he wanted for his 40 percent interest? Would you have any idea offhand?

Well, it was so depressingly little. He wanted \$800,000 which he would accept in 6-percent notes if they were bankable. That was in parentheses, if they were bankable. Well, here is a man who has had a tremendously successful company in a great growth industry, and for

40 percent of it, all he gets is \$800,000. Now, it is not a lot of money. I mean it really is not for the size which he has attained. I mean management companies really are not very profitable. That is the fact of it.

Mr. KEITH. No further questions, Mr. Chairman.

Mr. Moss. I am not going to labor the point with you, but I can only say this: This statement that it will involve a cut in the load from $8\frac{1}{2}$ to $6\frac{1}{2}$ and at the same time strengthen the economics for the independent dealer and his salesman, "This plan is nonexclusive and because of the benefits to all involved we believe it will be copied throughout the industry."

"As you know, the NASD's administrative authority to approve or disapprove this plan is absolute and final."

Now, you are saying that they could approve a plan that would take all of these funds down to a load charge of $6\frac{1}{2}$ percent? Is that what you are saying?

Mr. ALGER. Yes. We specifically recommended it for our management company.

Well, for instance, you have a member here in this room, Mr. Roland Robbins of First Investors, who is on the standing committee.

Mr. Moss. Let's stay to this question.

Mr. ALGER. He could explain it to you better than I.

Mr. Moss. Oh, I do not want anyone else to explain your statement to me. I want you to explain your statement to me. I have quite a number of staff that I can have go over it and explain it. I want to understand quite clearly what you intend to convey to the committee.

Mr. ALGER. The point I was making and trying to make is that I do feel that if the smaller funds, more robust funds had the right to innovate with marketing—you see there are certain problems with the marketing structure as it exists now. For instance, the big problem is if you want to cut the load how do you keep the independent broker-dealer in business.

Mr. Moss. I know, but we have a very specific statement. You say that the "NASD's administrative authority to approve or disapprove is absolute and final."

Mr. ALGER. That is correct.

Mr. Moss. Is not the NASD action subject to review by the Securities and Exchange Commission? And does that not have the effect of staying an action?

Mr. ALGER. According to my lawyers, it does not. Evidently, and it is just a thing that is in the act itself—

Mr. Moss. Well, I can only say that you and your lawyers are either confused or I and my lawyers are confused. You could cut the load on your plans, the plans you advise, to $6\frac{1}{2}$ without any NASD approval, could you not?

Mr. ALGER. Yes, we could, but we could not come in with—for instance, as I say, we plan to use a portion of the management fee to contribute to a pension fund of salesmen through independent broker-dealers.

Now, to do such a plan, even though it is fully revealed in the prospectus and spelled out, and is a part of the discounts and concessions which we would offer, because after all we are cutting the load, to do such a thing we would have to get approval of the NASD.

Mr. Moss. You could engage in the very common practice of giveups you receive from your brokerage in order to stimulate a sales force or to enrich the amount that the sales organization, could you not?

Have you submitted a proposal to the SEC that they have rejected?

Mr. ALGER. They sent it back to the NASD.

Mr. Moss. For what, for comment?

Mr. ALGER. No, for approval. Then they will look at it if the NASD approves it.

Mr. Moss. But you said it is final and absolute.

Mr. ALGER. That is correct.

In other words, if the NASD disapproves it, then we have no right to go to the SEC with it.

Mr. Moss. I have no further questions.

Mr. Watkins?

Mr. WATKINS. None.

Mr. Moss. Thank you very much.

The next witness will be Mr. Edward B. Allen, Jr., secretary-treasurer of Allen, Rogers & Co., Inc.

You may proceed, sir.

STATEMENT OF EDWARD B. ALLEN, JR., SECRETARY-TREASURER, ALLEN, ROGERS & CO., INC.

Mr. ALLEN. Thank you.

I would like to beg your indulgence and ask if you would move down in your thinking from the management fee, and the portfolio management, and the boards of directors of funds and so on, and come down with me if you will to the grassroots of this business, and talk more or less about the people end of it, that is those who are selling it.

Mr. Moss. We are very pleased to do that.

Mr. ALLEN. And those who are buying it.

Mr. Moss. All right, sir, we will be pleased to hear from you on that.

Mr. ALLEN. Perhaps I am the answer to Mr. Keith's question of a little while ago that it would be nice if we had a salesman here. I hope at least to some degree I qualify, Mr. Keith.

Our company is a relatively small dealer specializing in mutual funds. We do some business over the counter, pretty much unsolicited. We do some listed business through a listed firm, but primarily we deal in the hiring, training, and supervising of sales representatives, registered representatives who go out and contact the public and interest them in what mutual funds can do for them.

Approximately 75 percent of our business is in contractual plans, and the rest of it is in outright cash purchases and so-called open accounts or dividend reinvestment programs. Various funds use different terms.

We have seven offices in New Jersey, eastern Pennsylvania, and Delaware at the present time, and about upwards of 200 salesmen, between 200 and 250 registered representatives right at this point.

The firm started 6 years ago when my two partners and I were affiliated with another underwriting firm and sold funds for them before opening up our own shop.

The initial reaction of our representatives, and ourselves to a great degree, when the SEC proposals were first rumored and then actually

came out, was one of shock and dismay. We felt that it was incredible that these recommendations were being made, because, you see, the sales representatives in most organizations such as ours, I think I can speak pretty much for other firms of our size, are a pretty dedicated group of people who, in addition to the fact that they obviously are in business to receive monetary compensation, they also are, for the most part, extremely interested in being of service to their fellow man. I have been in the military as an enlisted man, as an officer, I was in the teaching profession, have a master's degree in education, taught for 10 years, coached athletics and so on, and believe me, there is no more dedicated a group of people than mutual fund salesmen, and they raised questions immediately when they heard of this report.

I can give you no specific examples but general ideas such as what is the SEC trying to do, put us out of business? Or it sounds to me like someone is trying to undermine the free enterprise system. Or what do they think, we are getting rich in this business?

And, of course, it did raise questions in our mind as to what could be the motives? The possibilities, of course, are political or personal gain or some such reason as this.

Mr. MOSS. I would prefer that you confine yourself to your statement on the subject you came here to discuss.

As one of the sponsors, I assure you that I have neither political nor personal nor pecuniary gains in mind.

Mr. ALLEN. I do not mean to imply that, sir.

Mr. MOSS. Well, you have succeeded quite admirably, so let's stay with the subject that we are here to discuss.

Mr. ALLEN. My next statement was to be that obviously we drew no conclusions in that direction at all. The only conclusion we could come to was that at least from our standpoint down at the grassroots, working with people out there every day, was that possibly the SEC did not fully understand the problems that we do have.

Mr. WATKINS. Mr. Chairman, I think we ought to let him express his opinion. He can file his report if he wants to.

Mr. MOSS. Mr. Watkins, the gentleman did not ask to file his report and summarize it.

Mr. WATKINS. Mr. Chairman, would you not permit him if he would request his statement be filed and then go on as he has? I think it is interesting.

Mr. MOSS. If the gentleman from Pennsylvania had been present, the chairman announced at the beginning of these hearings and well in advance that it would be necessary for every witness appearing to submit at least 24 hours in advance a statement of what his testimony would be. The gentleman is not now confining himself either to a summary of his statement or to the statement which he has presented to this committee in accordance with the rules of the committee and the rules of the House.

The gentleman will therefore confine himself to the statement he has presented here as his statement. He may summarize it if he wishes, but the rules of the House and the rules of the committee permit that type of requirement and that type of requirement will be imposed as long as I am chairman of this subcommittee.

Mr. WATKINS. Now, Mr. Chairman, I do not mean to be disrespectful. I have a lot of respect for you and your ability and your knowledge

of the law and all, but this gentleman does not. So can we not be a little lenient with a witness that comes up here—

Mr. MOSS. I have been most lenient. The gentleman has been here presenting a statement which is totally extemporaneous and totally irrelevant, and not related in any sense to the statement he prepared to submit to this committee as his statement.

Mr. WATKINS. I will have to submit, of course, to the ruling of the Chair and I shall, but I would suggest to you in my behalf that you give me some of these grassroots opinions in writing. I would like to have them.

Mr. ALLEN. Thank you very much.

Mr. MOSS. The gentleman is supposed to be here to give us grassroots opinion and he has carefully prepared them.

Mr. WATKINS. The remarks he did not put in the report, let's put it that way.

Mr. MOSS. The gentleman can do that in his questioning.

Mr. WATKINS. I do not believe in being the judge, court and jury in this thing.

Mr. MOSS. The Chair does not intend to pursue the discussion any further.

The gentleman will proceed and proceed in order.

Mr. WATKINS. I accept your decision. I think I told you that. You do not have to be so stern about it.

Mr. ALLEN. I respectfully request that the statement be made a part of the record.

Mr. MOSS. The statement will, if there is no objection, be included at this point in its entirety.

(The prepared statement follows:)

STATEMENT OF EDWARD B. ALLEN, JR., SECRETARY-TREASURER, ALLEN, ROGERS & Co., INC.

A. MUTUAL FUNDS AND THE REGISTERED REPRESENTATIVE

In the first twenty (20) years or so of the forty-six (46) years Mutual Funds have been in existence, the total assets of all Funds grew from zero (0) to approximately five hundred million dollars. In the last twenty-three years this figure has increased to approximately 45 billion dollars. The reasons for this rapid growth in these recent years may be attributed to the following:

- (1) Rising security prices reflecting the tremendous growth and earning power of American Industry.
- (2) The generally excellent Management, relative safety, and many conveniences of Mutual Funds.
- (3) The growing affluence of our society.
- (4) The declining purchasing power of the dollar.
- (5) The excellent cooperation between our Government and our industry to set legal safeguards and high ethical and professional standards.
- (6) The efforts of Registered Representatives to bring the above factors into sharp focus and correlate them with the personal financial planning of people in all walks of life.

We would not for a moment wish to minimize the importance of the first five (5) reasons. However, the major influence, without a doubt, affecting the gratifying increase in the number of shareholders of both modest and wealthy circumstances, may be attributed largely to the efforts of Registered Representatives.

By the S.E.C.'s own admission in its report, Mutual Funds have performed a very worthwhile and valuable service to the people of our country: "Mutual Funds are *sold*. They are not *bought*. Therefore, the Registered Representatives have been, are now, and, unless the S.E.C.'s recommendations are enacted into law, will continue to be, an indispensable part of this valuable service."

B. A BREAKDOWN ON SALES CHARGES AND COMMISSIONS

Although it seems reasonable to assume that Congress is not interested in regulating prices, knowledge of how the clients' sales charge in Mutual Funds is distributed should prove interesting. These charges apply generally to sales under \$25,000 and are scaled down on larger sales. The Dealer-Representative commission ratio shown are our Company's. Other Dealers may vary their commission ratio somewhat.

1. Charge to investor—8%

2. Dealer receives—6% on most funds

3. Managers receive—5%, leaving 1% for the house

4. Sales Representatives receive $4\frac{1}{2}\%$, 4%, or $3\frac{1}{2}\%$ depending upon level of experience and accomplishment. The Managers receive, in override, the difference between these rates and 5%. This compensates them for hiring, training and supervising the representatives under them.

If the S.E.C.'s economically impractical proposal of a 5% Sales Charge is enacted into law, one does not have to be a financial wizard to see that firms like ours would simply be legislated right out of business. The Dealer concession would be lower than we now pay our managers and top representatives and representatives could not afford to stay in the business at $1\frac{1}{2}\%$ or 2% sales commission. Therefore, since they would no longer bring this vital service to the public, the S.E.C. folks would be doing a disservice to the very people they purport to protect.

With all due respect for the S.E.C., personally, I strongly resent the implication that for my 12 years in this business, I have been overpaid for my services. In actuality, every client in all those years who has carried out my recommendations has made money. No one has lost a dime.

C. UNFAIR COMPARISONS

If indeed the sales charge is too high, as alleged, it must be too high in relation to the service rendered, or too high in relation to other services believed to be of a similar nature. These are matters of opinion to be settled in the free enterprise market place. It is interesting to note that the only complaints about Funds are from the S.E.C. and not from shareholders.

The following is a comparison in costs between Funds and individual stocks based on \$5000 in an individual stock.

Funds:

8 percent to Buy

No charge to sell.

Stock:

1 percent to buy

1 percent to sell (approximately).

Funds are purchased to keep, not to sell. Stocks are usually bought to sell at a future date. Let's assume that a buyer turns over his stock 3 times a year. That would result in a 6% total sales charge in a year or 60% in 10 years.

The next example is \$5000 in 50 stocks listed on the N.Y. stock exchange:

Amount invested	
Amount in each stock	\$5,000.00
Price per share	\$100.00
Number of shares in each stock	\$50.00
	2
Buying cost:	
Odd lot differential	
Brokerage fee	
Selling cost:	
Odd lot differential	\$12.50
Brokerage fee	300.00
State tax	12.50
SEC fee	300.00
	5.00
	.50
Total in and out fee	630.50
Percent of invested amount (percent)	
Mutual fund cost: \$400 or 8 percent.	12.61

Not only is there a difference in charge but a more significant difference is that of method, purpose and planning involved. The average customer's man in a brokerage firm must make several trades a day usually over the telephone or with the client in his office watching the board, in order to make a decent income.

On the other hand, the Mutual Fund representative takes a different approach, since he is interested in overall financial planning for his clients. He spends hours prospecting, personally interviewing to determine needs, abilities and long term goals, planning programs to meet such objectives as education of children, retirement plans, or current income needs from investments. If he is progressive, as he ought to be, he also plans and coordinates life insurance programs, works with attorneys on trusts, sets up corporate and personal tax-sheltered retirement plans. Instead of several sales a day, he is fortunate to make two (2) sales a week and many times spends weeks on a single case. His job is to tailor a plan to individual, family or business needs.

He believes that only *after* such things are taken care of should a person indulge in the more precarious practice of playing the stock market.

The Mutual Fund Industry is one which:

1. Sends thousands of young men and women to college.
2. Provides a dignified retirement for hundreds of thousands of older people.
3. Protects millions of people from the ravages of inflation.
4. Gives people of all walks of life the best plan ever devised to provide a sound method of participating in the growth and earning power of American Industry.

D. THE CONTRACTUAL PLAN

Experienced persons in financial planning know that the vast majority of people, even though they live in the wealthiest country the world has ever known, end up broke after a lifetime of work. The reason for most is that they never had any plans to end up any other way. Since most people do not have \$2,000, \$5,000, \$10,000, \$50,000 or \$100,000 to invest, their only salvation to achieve the above goals, is to save out of their income. This should be done on a planned systematic basis rather than on a hit or miss basis. The only plan that makes real sense is the Systematic Investment Plan or so-called Contractual Plan.

The advantages of this plan far outweigh the one disadvantage. The *only* disadvantage is that if the shareholder liquidates in the early years he would probably withstand a loss. It is the same disadvantage one finds in a mortgage, life insurance policy, buying a car on time, etc.

The client has this fully explained to his satisfaction before he embarks on a program. A plan for education of children or for retirement is extremely important in financial planning. This plan provides a self-imposed semi-obligatory program to accumulate capital to take care of future inevitable financial needs. It gives all the possible advantages and conveniences of an investment in American Industry and reduces the risk to a minimum.

See exhibit A—"Contractual Plan Results" which shows values of plans at various stages of accomplishment as well as salesman's commissions earned.

See exhibit B—"Some Advantages of the Contractual Plan."

E. HIRING AND TRAINING PERSONNEL

Because of the high standards required for registration and licensing, it takes about two (2) to three (3) months of study and training and examinations before an applicant is qualified to solicit sales. Our firm has hired, trained and released about 500 people in 6 years to retain the present 250 representatives. Most firms operate on a straight commission basis. No draw or salary. Many representatives are part time. It is difficult to ascertain why all this is so if salesmen in this industry are paid such a high commission, as alleged by the S.E.C. Why do not more customer's men leave the individual stock business and sell Mutual Funds exclusively, if there is so much money in it?

F. CONCLUSIONS

1. Well-informed citizens, who believe in the free enterprise system, are capable of judging the value of Mutual Fund purchases, i.e. costs vs results.

2. The sales charge on fund shares purchases and contractual plans is completely fair and fully justified in light of the service rendered.
3. The contractual plan is the finest and most sensible investment vehicle ever devised for investing regularly in American Industry. The many advantages and conveniences far outweigh the one disadvantage.
4. The Registered Representative is generally a hard working, conscientious, well-trained person who has his clients best interests at heart. His services usually extend far beyond the mere sale of Mutual Funds.
5. The sales charge in Mutual Funds cannot be equated with that of stocks per se.

EXHIBIT A

STATUS OF SELECTED CONTRACTUAL PLANS AS OF OCT. 2, 1967

Name	Monthly plan	Face amount	Number of investments ¹	Amount invested	Value	Salesman's commission ²
1. G. B.-----	\$50	\$9,000	6	\$300	\$151.74	\$67.50
2. G. O.-----	100	18,000	15-8b	3,500	1,247.64	292.50
3. W. D.-----	30	3,600	17-46b	510	714.12	87.75
4. J. A.-----	50	6,000	26-34b	1,300	1,428.24	87.75
5. J. H.-----	25	4,500	28	700	730.35	146.25
6. C. F.-----	30	3,600	38-20b	1,340	1,752.76	73.19
7. A. P.-----	50	6,000	56	4,800	4,025.04	87.75
8. C. C.-----	75	9,000	63	4,725	8,147.46	146.25
9. P. B.-----	60	7,200	66	3,960	6,540.69	219.57
10. F. I.-----	100	12,000	69	6,900	11,588.22	175.50
11. A. G.-----	25	3,000	72	1,800	3,035.01	292.50
12. P. T.-----	500	60,000	72	36,000	66,704.70	73.19
13. H. R.-----	100	12,000	83	8,300	13,389.75	292.50
14. E. S.-----	50	6,000	96	4,800	9,040.11	146.25
15. J. S. ³ -----	25	3,000	120	3,000	4,787.85	73.19
16. F. M. ³ -----	100	12,000	120	12,000	15,370.00	492.50
Totals-----	1,370	174,900	947	89,735	148,653.72	3,210.39
Total amount invested-----					89,735.00	
Unrealized gain-----					58,918.72	

¹ 2nd number indicates number of payments behind.

² Starting Salesman's Commission spread over 1st year.

³ Completed Plans.

Note: All above plans have been in existence for less than 6 years. Actual confirmations of the above records will be furnished upon request.

EXHIBIT B

SOME ADVANTAGES OF THE CONTRACTUAL PLAN

1. Diversification.
2. Professional Management.
 - (a) Careful Selection.
 - (b) Constant Supervision.
3. Distribution of Dividends Earned.
4. Distribution of Realized Profits.
5. Automatic Reinvestment at no cost.
6. Bank Custodian Services.
7. Certified Public Accounting.
8. Monthly Accounting and Reminder Notices.
9. Periodic Fund Reports.
10. Accelerate or De-celerate Monthly Investments without penalty.
11. Low Cost Completion Insurance.
12. 90% Withdrawal Privilege.
13. Redemption of Shares at no cost.
14. Transfer Privileges.
15. Systematic Withdrawal Plan.
16. Use as Collateral.
17. Tax advantages.
18. Designation of Beneficiary.

19. Adaptable to Gifts and Trusts.
 - (a) Revocable and Irrevocable.
 - (b) Gifts to Minors.
 - (c) Profit Sharing Plans.
 - (d) Keogh Self-employed Retirement Plans.
 - (e) Short-term Trust.
20. Year-end Tax Information.

Mr. MOSS. The gentleman may summarize the statement.

Mr. ALLEN. I shall try, Mr. Chairman, to exercise as much restraint as I can.

The thing that we find out there in the field is that, generally speaking, most people do a rather poor job of personal financial planning, and I think all the statistics will bear out that after a lifetime of work in the wealthiest country that has ever been on the face of the earth, that many, many people end up quite broke. Those of us in the sales end of this business, I think, are in the forefront of an endeavor to try and bring into focus the needs of people and correlate them with their ability to set money aside and to correlate it also with the economic times in which we live, and offer plans and programs to that end.

And what this industry has done, and primarily through the sales representative, has been to send thousands of young men and women to college, has resulted in a dignified retirement for hundreds of thousands of older citizens, has protected millions of people against the ravages of inflation, and if we may be a little prejudicial, given people the best plan that has ever been devised to offer a participation in the growth and earning power of American industry. And I submit to you that mutual funds are a product or a service which is sold and not bought, very similar to life insurance. Very few people go down to Prudential or Metropolitan or John Hancock and walk in and say, "I would like to buy some life insurance."

Mutual funds are pretty much the same. People do not generally seek out this service. It must be brought to them. And this requires salesmen who spend long hours prospecting, interviewing, planning, and if they are progressive in their thinking, probably correlating it with life insurance. They deal with attorneys in setting up trusts, work with self-employed retirement plans and with profit-sharing and pension plans in industry, and it is simply our contention that they should be paid for these services. It would seem that the SEC would want this compensation reduced and to decide just how much it should be.

If I may, I should like to break down the sales charge on a lump-sum investment. The client generally pays about 8 percent. This is assuming it is not a no-load fund. The dealer concession usually is about 6 percent.

Mr. KEITH. You mean if somebody puts a lump sum down they pay 8 percent at that time?

Mr. ALLEN. Yes. If a man invests \$1,000, the sales charge is \$80, the sales charge to the client.

Mr. KEITH. At the time he puts it down, the total commission on a plan other than a lump sum, it works out to be about the same thing, if you see what I mean.

Mr. ALLEN. No, I am sorry, I do not follow you.

Mr. KEITH. If he is buying on the installment plan, he would be paying 8 percent over a period of years?

Mr. ALLEN. Yes.

Mr. KEITH. And if he bought a lump sum of \$1,000 each year, he would be paying \$80 or 8 percent?

Mr. ALLEN. That is correct, the difference being that on a contractual plan, of course, that the major portion of the sales charge comes out the first year, but in the end when the man completes the plan—

Mr. KEITH. He is paying everything in the first year if he only puts in the lump sum. He is paying the 8 percent.

Mr. ALLEN. No. Let me give you an example if I may.

Let's assume a man is just buying \$1,000 worth of XYZ fund.

Mr. KEITH. Yes.

Mr. ALLEN. He buys \$1,000 worth of shares, that is, minus 8 percent. He buys \$920 worth of shares. The 8 percent is the sales charge to him. And then if I may, I would like to show you how this is divided.

The dealer concession generally is 6 percent. We as dealers, have managers under us who receive 5 percent, leaving 1 percent for the house, so to speak, for us as the dealers. Now this breakdown of course will vary somewhat with other dealers. Although there is only so much one can work with, some firms will vary these percentages slightly.

I am using our firm as an example here. Salesmen generally will receive $4\frac{1}{2}$, 4, or $3\frac{1}{2}$ percent, depending upon the level of accomplishment, length of service, or whether they are working their way into management and so on.

Now it is a little hard for us to understand that if the overall sales charge were reduced to 5 percent, how we could work out a system of compensation for our salesmen which would hold them, which would keep them with us as salesmen, and frankly, how we could stay in business.

Mr. WATKINS. How could you sell if you did not have salesmen? People do not come to you like they would a doctor, do they?

Mr. ALLEN. No, that is correct, very seldom. The longer one is in the business, the more this does happen, but it is an occasional thing. No, we just could not operate.

Mr. WATKINS. In other words, what you are saying, if you cut it down to 5 percent you are out of business then?

Mr. ALLEN. Absolutely.

Mr. WATKINS. That is what I want to hear you say here. All this going around the bushes about some of this other I am not interested in.

Mr. ALLEN. In our opinion this is exactly what would happen, because we could not compensate salesmen to go out and sell this service. The only kind of dealership that we could have would be one where I suppose my partners and I would be alone in the business, and let's say the concession to the dealer was $3\frac{1}{2}$ percent. Proportionately I guess it would be something like that.

So that we as principals would be the only ones selling and we would be receiving a $3\frac{1}{2}$ -percent commission on what we personally would sell. Well, it is pretty obvious we would get out of this business and go into some other business.

Mr. WATKINS. Mr. Allen, how many men did you say you employ in your firm of Allen, Rogers & Co.?

Mr. ALLEN. About 240 or so I think at the moment.

Mr. WATKINS. You are telling this committee now that those 240 people would be out of work?

Mr. ALLEN. Yes, sir. I do not see anything else that could happen, because they are just not going to work for that little compensation.

Mr. WATKINS. You could put them on relief.

Mr. ALLEN. Well, maybe we can raise social security benefits.

Mr. WATKINS. They can wind up on relief, do not do anything, get paid, get a check sent to them once a month. We could do that.

Go ahead, Mr. Allen.

Mr. ALLEN. If I may go into this a little further, as regards the contractual plan. As far as we are concerned, and we may be prejudiced, the greatest single vehicle that has ever been made available for average Americans and people of modest means to secure an investment in American industry has been the contractual plan, because it adequately compensates the salesman for spending the time with this little guy, so that he can invest \$25, \$30, \$40, \$50 a month.

There is only one disadvantage to the contractual plan, and that is, if the shareholder liquidates in the early stages, he will lose. This is always pointed out to him. I perhaps shouldn't say always. There may be some salesmen somewhere who don't, I don't know, but we certainly haven't had any complaints on it ourselves.

The chief determinant, I think, as to what the sales charge should be, doesn't necessarily bear any relation to the performance of the product or anything of that nature. It bears a relationship to what it costs to do business, what it costs to get a salesman to go out and do the job. The markup on a diamond ring I suppose is 50 percent or something, I don't know; on a suit of clothes maybe 40 percent; an automobile, maybe 25 percent, and a can of beans two percent.

The reason for the charge, I think, is related to the cost of doing business, and it is important to us what it costs us to do business and what we have to pay out in terms of overhead in order to stay in business. And as I said, the shareholders have not complained. It seems that the SEC are the only ones that have complained about the sales charge.

If I may give an example of the difference between an open account and a contractual plan in terms of what the salesman earns, an open account simply being a level charge plan, where 8 percent is taken out each time an investment is made. If a man is going to invest \$100 to begin with, and \$50 a month as he would on a contractual plan, and if we set up an open account the same way—although, generally speaking, most of the funds don't do it that way—some funds have a minimum of perhaps \$500, some \$150, to open an account, and then the investor may add in \$50 increments if, as and when the investor feels like it.

On the open account, out of the first \$100, the salesman would receive $3\frac{1}{2}$ percent, or \$3.50 out of this \$100. Picture now, he has called this person, made an appointment, perhaps called many persons before he got the appointment with this prospect, and is spending his time going out to talk to this man.

You see, many times this business is equated with the customer's man in a brokerage firm who makes most of his sales over the phone,

and does it in a relatively short time. In the mutual fund end of it, the salesman goes out and sits down with the client or brings him into the office and, as I said before, correlates this whole program for him and tries to set up a plan and a program to meet his needs, his objectives, his hopes, his dreams for his children's education and his own future, and so on.

So let's assume that a representative has 50 of these open accounts going. It means that he will get \$1.75 every month if this client puts in \$50. If he has 50 of these plans going let's say, this is \$87.50 a month income to him. Assuming 20 percent attrition along the way, this is more like \$60 a month income to the salesman, if all he sold was open accounts.

On the contractual, on the other hand, a man puts in \$100, the salesman would make something like \$22.50 out of the first \$100 and \$11.25 out of each \$50 in the first year, and if the salesman, the representative, had 50 of these plans going, this would be \$562.50 monthly income to him, and again assuming that the same attrition involved here is 20 percent, which incidentally, our records prove would not be so because people carry out contractual plans and they don't carry out open accounts to anywhere near as high a degree. However, this would result in about \$450 a month income to the salesman as compared with \$60 a month in the case of the open accounts, or level charge plans.

I think you will agree this is not a very high income, average or below average. So the registered representative would have to have many, many more than 50 plans going, and in the case of the average representative, it will take him at least a year to institute 50 plans.

Well, if we had to sell only the open account, as I said before, we would just be out of business. The only other alternative would be for the registered representative, and we ourselves as dealers, to deal only with wealthy people who could put in thousands of dollars, and thereby we could get an adequate commission and income for ourselves, or we could go into another business.

Mr. Moss. Mr. Allen, do I understand you to say that this condition would arise if you did not have the contractual plans, the front-end load plans?

Mr. ALLEN. Yes, sir.

Mr. Moss. How do you explain then the strange phenomenon of my State of California, where with about 10 percent of the population of the Nation, we merchandise 23 percent of the mutual fund shares? There isn't another State that equals it.

Mr. ALLEN. I understand that.

Mr. WATKINS. It is a large State.

Mr. Moss. Does that give the selling forces more vigor, more initiative?

Mr. ALLEN. I think that one interesting statistic to investigate would be what the average sale is in California.

Mr. Moss. We are going to do that.

Mr. ALLEN. Because in order for a salesman representative to make a decent income in California or anywhere else, he would have to make relatively large sales, and it would seem to me that this might

be discriminatory against the smaller man who can only invest \$25 or \$50 a month.

Mr. MOSS. With all kindness, sir, I would suggest that you are leading yourself down a rose path that you shouldn't wander on, unless you have the statistical data to back it up, because you may find that the average sale there is no larger than it is out your way.

Mr. ALLEN. It would be mighty interesting.

Mr. MOSS. You may find that the average investor is being encouraged as much or more than out your way.

Mr. ALLEN. Possibly. I have never been to California, so I don't know.

Mr. MOSS. So I just would suggest that it would not be the act of greatest wisdom to go ahead and commit yourself too far along that path that we are only selling to the wealthy. I am not willing to concede that we have that mix of wealth in our population that would produce that phenomenon. There are other States I think with a higher income per capita than we have.

Mr. ALLEN. Well, from where I sit, in looking at our problem here, and what we would have to face, you ask me why this happens in California. My natural reaction would be that in order to make an adequate income, that a man would have to sell more. I don't know, if he doesn't—

Mr. MOSS. They might be better salesmen, isn't that right?

Mr. ALLEN. Possibly. I don't know, we haven't expanded as far as California, but we don't seem to find a great deal of difference between salesmen in say north Jersey and Delaware or Lancaster and Millville. Whether they are different in California or not I really couldn't say.

Mr. WATKINS. Mr. MOSS can't tell you much about those places, can you, Mr. MOSS?

Mr. MOSS. I have visited them, Mr. Watkins.

Mr. WATKINS. We want you to come down, too. We would like you to see more of them.

Mr. MOSS. I have enjoyed it too.

Mr. ALLEN. Well, we do feel that the elimination of the contractual plan would drive representatives and firms like ours out of business. I think it would also deprive a lot of average people from the service which is now being rendered to them, and in essence would ultimately hurt the very people that the SEC purports to protect.

It would seem somewhat discriminatory against smaller firms like ours, because whatever business, if we were to go out of business, whatever business would be sold in mutual funds, it would seem to me would go through the larger, wealthier firms who would perhaps sell it incidentally to their general brokerage business.

Mr. WATKINS. Do you sell life insurance in your firm?

Mr. ALLEN. Yes, we do. We have, I guess, about a third of our representatives who are life insurance salesmen also. This, of course, is one possibility that we have speculated on, and that is if this bill were enacted into law that we would have to go, this is one avenue, we would have to go into the life insurance business.

Mr. Moss. Are you a general agent at the present time?

Mr. ALLEN. Yes.

Mr. Moss. For the life insurance business.

Mr. ALLEN. Yes, we are.

Mr. Moss. And you are a broker/dealer in addition.

Mr. ALLEN. Correct.

Mr. Moss. Do you specialize in any particular funds?

Mr. ALLEN. Oh, no.

Mr. Moss. You sell anything that is available.

Mr. ALLEN. Any funds.

Mr. Moss. With no concentration on any one of them.

Mr. ALLEN. Oh, yes. I would say we concentrate on a particular group, although we do not tell our salesmen that they must sell this particular group, but various funds do give added concessions for a percentage of the business that a firm will do with them, and so we do a large portion of our business, I would say 80 percent, in one particular group of funds.

When we first went in the business 6 years ago, we looked into many of the funds, having been with an underwriter before, and were selling only one particular group of funds, and realizing—

Mr. Moss. What is the nature of that added incentive?

Mr. ALLEN. Oh, on the contractual plans in particular, I couldn't give you the exact figures, but there is an additional compensation in doing an additional amount of business per quarter.

Mr. Moss. Do you have an idea what it is?

Mr. ALLEN. And we pass this in incidentally to the salesmen.

Mr. Moss. You have an idea of what it is, don't you?

Mr. ALLEN. A half million dollars a quarter I believe it the latest figure in face amount of plans.

Mr. Moss. What is the added incentive that applies to this half million dollars a quarter?

Mr. ALLEN. Well, there are so many different sized plans that I couldn't tell you right offhand just exactly. I could certainly get it for you.

Mr. Moss. Will you supply it for the record?

Mr. ALLEN. Surely.

(The information referred to follows:)

EXAMPLES OF VOLUME BONUS ARRANGEMENTS OF FUNDS WHICH HAVE CONTRACTUAL PLANS

EXCERPT FROM THE DREYFUS FUND INCORPORATED PROSPECTUS, DATED MARCH 21, 1967

The Programs are established under an Agreement between The Dreyfus Corporation and The Bank of New York, dated July 18, 1955, are governed by New York law, and constitute an investment company of the unit investment type under the Investment Company Act of 1940. They are registered with the Securities and Exchange Commission under such statute, which does not imply supervision of management or investment policies by the Commission or any Governmental agency.

Programs are available from authorized independent dealers. These dealers currently receive commissions from The Dreyfus Corporation ranging from 54% to 90% of the full 10-year or 15-year Sales and Creation Charge. Dealer commissions on Fully Paid Programs ranged from 7.5% to .9% of the face amount of the Programs. Some dealers, because of their higher volume, receive additional

commissions ranging from 3% to 11% of the standard commissions. A special arrangement has been entered into with one foreign dealer because of its additional costs, unique problems, and high volume; under this agreement that firm is paid a higher rate than other dealers. Also, some of the higher volume dealers receive 108% of the standard commissions allowed to dealers on second through tenth or fifteenth year payments. The commission rates may be revised from time to time by The Dreyfus Corporation.

EXCERPT FROM THE OPPENHEIMER MANAGEMENT CORPORATION PROSPECTUS DATED
MAY 1, 1967

The General Distributor of OSCAP Plans is Oppenheimer Management Corporation (the "Management Corporation") 5 Hanover Square, New York, New York 10004. The Management Corporation is also General Distributor of the shares of Oppenheimer Fund as well as Investment Adviser to the Fund. As such General Distributor, the Management Corporation may be considered as the Underwriter of OSCAP Plans and the shares of Oppenheimer Fund as that term is used under the Securities Act of 1933. As General Distributor, the Management Corporation receives compensation from the sales charges deducted by the Custodian from payments by Planholders and on sales of shares of the Fund. A major portion of such sales charges is reallocated to dealers through whom Plans are sold.

On Single Payment Plans dealer commissions currently vary from .90 of 1% to 7.98% of the offering price. On Systematic Capital Accumulation Plans, With or Without Insurance, commissions currently vary from 80% to 95% of the sales commissions deducted from the first year's monthly payments and from 35% to 70% of the sales commissions deducted from the remaining payments.

Dealers may under certain circumstances receive in the calendar year in which they qualify:

(A) Yearly Production Bonus equal to 5%-10% of the total OSCAP commissions (Single Payment, first year and trail commissions) paid to them during the calendar year in which they qualify.

(B) Yearly Service Bonus equal to 1/20th of 1% to 1/10th of 1% of the total net asset value of all shares credited to the OSCAP accounts of their clients as of the end of the calendar year in which such dealers qualify.

* * * * *

During the year ended December 31, 1966, selling charges on the shares of the Fund's stock amounted to \$941,358 on 1,689,035 shares. Of the foregoing Oppenheimer & Co. received \$174,289 including \$57,318 as General Distributor and \$116,971 as Dealer; \$710,004 was reallocated to other dealers. Oppenheimer Management Corporation was appointed General Distributor June 28, 1966 and received \$57,065. Oppenheimer & Co. as General Distributor for the Oppenheimer Systematic Capital Accumulation Program received \$317,137 for its services and it also received \$48,657 for services as dealer for said Plans.

For the year ended December 31, 1966, the net investment advisory fee received by Oppenheimer Management Corporation was \$703,340, after allowing against the fee of \$761,219 a credit of \$57,879 for certain salary and related expense paid directly by the Fund. As of December 31, 1966 there was a reserve for advisory fee of \$606,735 the payment of which is contingent upon the realization of investment gains.

For the year ended December 31, 1966 total brokerage commissions paid amounted to \$710,331 of which Oppenheimer & Co. received \$421,925 at customary rates.

Oppenheimer & Co. has a broker's blanket indemnity bond of \$10,000,000 covering partners and employees and the employees of the Fund and the Management Corporation.

EXCERPT FROM FIDELITY CAPITAL FUND, INC., PROSPECTUS DATED APRIL 28, 1967

The Plans were organized under and are governed by the laws of the Commonwealth of Massachusetts. The Plans are considered to be a unit investment trust under the Investment Company Act of 1940 and are so registered with the Securities and Exchange Commission. Such registration does not imply supervision of management or investment practices or policies by the Commission.

Commissions ranging from 64% to 89% of the total Creation and Sales Charge will be paid to authorized investment brokers and mutual fund dealers who are members of the National Association of Securities Dealers, Inc. and who have executed a dealers agreement with the Sponsor. These dealers and investment brokers are independent contractors and nothing contained herein or contained in other literature and confirmations issued by the Sponsor or the Custodian, including the words "representative" or "commission", shall constitute any dealer or investment broker a partner, employee or agent of the Sponsor or the Custodian. Neither the Sponsor nor the Custodian shall be liable for any acts or obligations of any such dealer or investment broker. Dealers who qualify by selling at least \$60,000 face amount of Plans sponsored by the Sponsor in any calendar quarter will be given a bonus commission amounting to 7½% of the first year Creation and Sales Charge. Dealers who qualify by selling at least \$250,000 face amount of such Plans in any calendar quarter will be given a bonus commission amounting to 12.4% of the first year Creation and Advance Sales Charge. Dealers who qualify by selling at least \$1,500,000, \$2,250,000, or \$3,000,000 total dollar face amount of Plans sponsored by the Sponsor in any calendar quarter, and such Plans constitute 60% of the dollar face amount of all Plans sold by the dealer during such calendar quarter, will be given a bonus amounting to 49%, 53%, and 56%, respectively, of the continuing years' Creation and Sales Charge. Under specified conditions a foreign dealer who does not sell within the continental United States receives a commission of 105% of the first year's bonus commission paid to dealers.

EXCERPT FROM THE TELEVISION-ELECTRONICS FUND, INC., PROSPECTUS DATED
JUNE 22, 1967

The Programs are considered to be a unit investment trust under the Investment Company Act of 1940 and are so registered with the Securities and Exchange Commission. Such registration does not imply supervision by the Commission of management or investment policies or practices.

Commission ranging from 64.5% to 77.6% of the total creation and sales charges in respect of Periodic Investment Programs calling for 120 monthly investments, and from 54.6% to 63.4% in respect of Programs calling for 180 monthly investments and up to approximately 88% in respect to Single Investment Programs, will be paid to authorized investment brokers and mutual fund dealers who are members of the National Association of Securities Dealers, Inc., and who have executed a selling group agreement with the Sponsor. In addition, broker-dealers under certain circumstances, are entitled to receive a production bonus equal to no more than 15% of the regular first year commissions and 100% of the regular continuing years' commissions on Periodic Investment Programs.

Mr. KEITH. Is this additional compensation trips to Bermuda and things like that for your sales organization?

Mr. ALLEN. Oh, no. It is all published in the prospectuses of the various funds and fully disclosed.

Mr. KEITH. What is the name of the fund that you sell most of?

Mr. ALLEN. The Fidelity group of funds. There are a whole group of funds. Obviously, in hiring and training salesmen, although obviously we can't restrict them to selling a particular group and have no intention of doing it, on the other hand, to try and train them to sell 300 odd funds and know everything about 300 odd funds is a monumental job.

The biggest thing that we are really selling in funds is the management, and this happens to be a group of funds which have done a very fine job in the past.

Mr. WATKINS. Mr. Allen, didn't the State of Pennsylvania pass a law permitting you to do business with, your companies, mutual companies to do business with the municipalities and county governments, invest in your firms, that is taxpayers' money that would be.

Mr. ALLEN. I am not certain of that, Mr. Watkins.

Mr. WATKINS. I think that is correct, if my memory goes back that far. I think it is sound. I know your business is sound. You have a very sound and reliable firm; not in my district either, Mr. Moss.

Mr. Moss. I would say that is your loss, Mr. Watkins.

Mr. ALLEN. Well, in conclusion, gentlemen, we feel that in the interests of everyone concerned, the investor, the dealer, the industry itself, the salesmen, that the SEC recommendations should not be enacted into law. It is just about as simple as that.

Mr. WATKINS. May I ask a question off the record, Mr. Chairman? It does not pertain to this.

Mr. Moss. Certainly, Mr. Watkins.

(Off the record.)

Mr. WATKINS. I have no questions, Mr. Chairman. I want to thank you for coming in here to testify before this committee.

Mr. ALLEN. Thank you very much, Mr. Watkins.

Mr. Moss. Mr. Keith.

Mr. KEITH. No questions, Mr. Chairman.

Mr. Moss. I want to join in thanking you also for your appearance, and if there are no further questions, the committee will stand adjourned until 10 o'clock tomorrow morning. We will meet in this same room at that time.

Mr. ALLEN. Thank you very much.

(The following letter was received by the committee:)

ALLEN, ROGERS & Co., INC.,
Bala-Cynwyd, Pa., November 10, 1967.

Mr. JOHN E. Moss,
Chairman, Subcommittee on Commerce and Finance,
Rayburn House Office Building,
Washington, D.C.

DEAR SIR: Enclosed find the answers to questions asked in your letter of October 26th. We hope they serve to give some insight into the operation of firms such as ours in the Mutual Funds and Life Insurance business.

In order to give a full year's picture, we have used figures applying to the calendar year of 1966.

1. Number of Representatives in Mutual Funds—233 at present; 198 in 1966.

2. Number of Life Insurance Agents—95 at present; 78 in 1966

3. Number selling other securities—all Representatives are eligible to sell other securities. However, all sales of this type are unsolicited and handled only as a service to our clients. In our entire organization only 393 stock transactions were handled in 1966. About 75% of these sales were in listed securities on which we make no commission, since we are not a listed firm. We almost always charge

N.Y.S.E. charges on over-the-counter securities. Consequently, we lose money on this regular stock business. We are not the least bit interested in this stock business. We are in the business of taking the necessary time to sit down and discuss personal financial planning with prospects and in recommending plans and programs to achieve their long term financial objectives. This is a vastly different business from that of the regular customer's man, who makes his living primarily by sitting on the phone all day taking buy and sell orders for stocks and bonds.

4. Number of full-time Representatives—33 at present; 25 in 1966

5. Number of part-time Representatives—200 at present; 173 in 1966

6. Average annual income for full-time Representatives \$9,708.00

7. Average annual income for part-time Representatives \$1,000.00

(These are gross incomes before expenses of doing business such as automobile, telephone, correspondence, etc., which the Representative himself must take care of. Also, the average age of Representatives is probably in the 40's, or the prime earning time of their lives.)

8. Amount of Mutual Fund Business in 1966

(a) Cash

\$ 3,519,489.00

(b) Face Amount of Plans \$13,960,550.00

9. Amount of Life Insurance Business in 1966

\$7,000,000.00 face amount (primarily term insurance)

10. Number of full-time men selling contractals (All 198)

11. Number of part-time men selling contractals (All 198)

12. Additional compensations to the firm from volume sales in contractals. This is explained in the prospecti of the several funds which were forwarded to you several weeks ago.

13. Amount of this compensation passed on to Representatives (see attached commission schedules)

14. Amount of reciprocal brokerage business—\$70,343.00

15. Amount of reciprocal earnings passed on to salesmen.

It is our policy not to pass any of this directly to salesmen. However, it results in our being able to pay more generous commissions to salesmen. Also, this reciprocal business makes up the major portion of profit to our firm and is the primary source of funds for our employees profit-sharing plan into which we put \$30,000.00 for the fiscal year of 1966. Also, such expenses as our annual convention, contest awards and the like come from this source. The rest goes to operating capital and dividends to stock holders.

If the present proposals were enacted into law the resulting drastic curtailment of income would result in the following possibilities as we see them at this time:

1. We would be out of business entirely

2. Our business would be drastically changed as follows:

(a) We would be forced to emphasize the insurance business and sell high cost, high commission insurance (which we do not now sell, because we think it is usually not in the best interest of the client).

(b) We would not solicit Mutual Funds sales and would sell them only as a strictly incidental part of the insurance business, or would accept only large sales which would result in an adequate commission for the time spent.

(c) Our profit-sharing plan would be thrown out, which would make our employees very unhappy because it would adversely affect their retirement plans.

We trust that this information will be helpful to the Committee and that their recommendations will be in the best interests of the public, the industry and dealers such as ourselves.

Sincerely,

EDWARD B. ALLEN, Jr.

SCHEDULES FOR BEGINNING SALESMEN

SCHEDULE A.—COMMISSION IN FUNDS WHERE VOLUME SALES APPLY

Monthly plan unit	Double 1st payment	Next 11 payments	Total commission
25.....			
30.....	\$11.26	\$5.63	\$73.19
40.....	13.50	6.75	87.75
50.....	18.00	9.00	117.00
60.....	22.50	11.25	146.25
75.....	27.00	13.50	175.50
100.....	33.78	16.89	219.57
125.....	45.00	22.50	292.50
150.....	56.26	28.13	365.69
	67.50	33.75	438.75

SCHEDULE B.—REGULAR SALESMAN'S COMMISSION IN FUNDS NOT ON VOLUME SALES

Monthly plan unit	Double first payment	Next 11 payments	Total 1st year
\$25.....			
30.....	\$10.10	\$5.05	\$65.65
40.....	11.60	5.80	75.40
50.....	15.70	7.85	102.50
60.....	20.00	10.00	130.00
75.....	25.00	12.50	162.50
90.....	32.00	16.00	208.00
100.....	38.00	19.00	247.00
150.....	42.00	21.00	273.00
	62.00	31.00	403.00

SCHEDULES FOR ADVANCED SALESMEN
SCHEDULE A.—COMMISSION SCHEDULE ON VOLUME CONCESSION

Monthly plan unit	Double 1st payment	Next 11 payments	Total 1st year	1 year trail	9 year trail	10 year total
\$20.....	\$10.00	\$5.00	\$65.00	\$1.75	\$15.75	\$80.75
25.....	12.50	6.25	81.25	2.25	20.25	101.50
30.....	15.00	7.50	97.50	2.75	24.75	122.25
40.....	20.00	10.00	130.00	3.60	32.40	162.40
50.....	25.00	12.50	162.50	4.50	40.50	203.00
60.....	30.00	15.00	195.00	5.25	47.25	242.25
75.....	37.50	18.75	243.75	6.50	58.50	302.25
100.....	50.00	25.00	325.00	9.00	81.00	406.00
125.....	62.50	31.25	406.25	11.00	99.00	505.25
150.....	75.00	37.50	487.50	13.00	117.00	604.50

SCHEDULE B.—COMMISSION SCHEDULE OF FUNDS NOT ON VOLUME CONCESSION

Monthly plan unit	(Double) 1st payment	Next 11 payments	Total 1st year	9 Year total 2d through 10th year	10 year total
\$25.00.....	\$11.10	\$5.55	\$72.15	\$20.00	\$92.15
30.00.....	12.90	6.45	83.85	24.00	107.85
40.00.....	17.40	8.70	113.10	32.00	145.10
50.00.....	22.00	11.00	143.00	36.00	179.00
60.00.....	27.40	13.70	178.10	41.00	219.10
75.00.....	34.00	17.00	221.00	52.00	273.00
90.00.....	40.50	20.25	263.25	63.00	326.25
100.00.....	45.00	22.50	292.50	70.00	362.50
150.00.....	68.00	34.00	442.00	102.00	544.00

(Whereupon, at 5:35 p.m., the subcommittee adjourned, to reconvene Tuesday, October 17, 1967, at 10 a.m.)

INVESTMENT COMPANY ACT AMENDMENTS OF 1967

TUESDAY, OCTOBER 17, 1967

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 2322, Rayburn House Office Building, Hon. John E. Moss (chairman of the subcommittee) presiding.

Mr. Moss. The committee will be in order.

We are pleased to welcome as our witnesses this morning Mr. Robert W. Haack, president of the New York Stock Exchange, Mr. Gustave L. Levy, chairman of the board of governors, and Mr. Donald L. Calvin, vice president, government relations.

Would you gentlemen come forward and take your seats.

STATEMENT OF ROBERT W. HAACK, PRESIDENT, NEW YORK STOCK EXCHANGE, ACCOMPANIED BY GUSTAVE L. LEVY, CHAIRMAN, BOARD OF GOVERNORS, AND DONALD L. CALVIN, VICE PRESIDENT, GOVERNMENT RELATIONS

Mr. HAACK. Mr. Chairman and gentlemen, I have with me a somewhat modified and, happily, abbreviated statement which varies only modestly from the one we filed last week. With your permission I should like to read it for the record.

Mr. Moss. Without objection the entire statement will be received for the record and you may summarize it.

(Mr. Haack's prepared statement follows:)

STATEMENT OF ROBERT W. HAACK, PRESIDENT, NEW YORK STOCK EXCHANGE

The New York Stock Exchange believes that the regulatory framework that was established in the Investment Company Act of 1940 has worked well. The proposals in the bills before this Committee, if adopted, may establish the regulatory pattern for investment companies for another generation of investors. For this reason we urge the Committee to give the most careful consideration to the SEC's proposals.

The Exchange's review of these bills raises a number of questions as to their potential impact on both the investing public and the securities industry. More specifically, we are concerned with the thrust of the changes proposed for three very basic reasons:

1. No mechanism is provided for the self-regulatory processes which are well established in other segments of the securities industry. It is our opinion that industry self-regulation should play an important and positive role in furthering the mutual fund industry's future growth.

2. New and, in some cases, novel proposals are made that are far-reaching and could prove detrimental to the interests of the investing public.

3. Little justification is given for many of the proposals in either the SEC's report on investment companies or in its technical analysis of H.R. 9510 and H.R. 9511.

THE IMPORTANCE OF SELF-REGULATION

Those who are actively engaged in the securities business recognize that their future success depends on the confidence of the public investor. If confidence is lost, so too may be their industry. Thus the industry regulates itself out of a self-interest which is consistent with the public interest.

In many instances the requirements which the Exchange imposes on our member organizations and listed companies are more strict than are required by the Securities Acts or the Securities and Exchange Commission. Other self-regulatory agencies including the other stock exchanges and the National Association of Securities Dealers, Inc. also impose regulatory requirements on their members.

As a result investors using American markets have working for them three layers of protection for their interests. First, the conviction of men in the securities industry that the confidence of investors is their most valued asset. Secondly, strong self-regulatory agencies and exchanges within the industry which can be flexible and responsive to changing conditions. Third, Federal and state governmental agencies and a system of laws designed to provide both the disclosure of information and protection of public interests. In our opinion it is in the public interest that all three layers of protection be continued and that this concept be embodied in the bills before this Committee.

LIMITATIONS ON SALES CHARGES

Abandoning the concept of self-regulation the Commission is seeking a statutory maximum on mutual fund sales charges of five percent of the net asset value of shares purchased. Further, the SEC asks that it be granted the sole authority to increase or change the maximum.

The Exchange opposes this proposal as not being in the public interest. We question the wisdom of asking Congress to turn its back on self-regulation in this area. The Commission makes no showing that the investment fund industry is, in fact, a public utility and hence must have its rates regulated by a governmental agency and nowhere in the Commission report is there evidence that it has made a detailed analysis of the economic consequences of a five percent maximum.

The Exchange strongly endorses the approach of strengthening self-regulation in this area. We recognize that a number of problems remain to be resolved if the self-regulatory approach is to be followed. We believe, however, that self-regulation is vastly preferable to the approach suggested by the SEC. The NASD would seem to be the most appropriate organization to be given this self-regulatory responsibility. The NASD regulates profits and markups in a number of other areas. This would seem to be a logical extension of that responsibility.

MANAGEMENT FEES

Proposed Section 8 of the bill would establish an entirely new standard in the law to give the SEC indirect rate making authority over management fees. The bill suggests that new concepts be introduced in our securities laws, existing law be repealed and numerous State court cases be overturned.

The Exchange feels that these proposals would work to the detriment of mutual fund shareholders by stimulating burdensome and costly litigation and making it increasingly difficult for the industry to find men of stature and independence to serve as directors. In our view the SEC proposals will not help funds to improve results for investors but may well hinder them in this effort. Further, there appears to be no basis for the implication that fund directors and shareholders are not fully competent to determine what fees and salaries are reasonable for investment advice and that this decision must be made for them by the courts.

We understand that the Investment Company Institute has indicated to the SEC its willingness to go beyond the present concept. As we understand that proposal, it contained three important points. First, the number of independent directors would be increased from 40 percent to a majority. Second, the independ-

ent directors of the fund would be required to make a specific finding, in the exercise of business judgment, that a proposed management fee contract is reasonable. Third, and finally, a fund shareholder could commence an action in a Federal court to recover, on behalf of the mutual fund, any portion of a management fee which the court found was unreasonable. In such an action, the court could upset a management fee contract upon the finding that the approval by the directors was an abuse of business judgment.

We think that this proposal minimizes any risk there may be to the public interest in this area and ought to be adopted.

CONTRACTUAL PLANS

In another proposal, the Commission urges the abolition of contractual or front-end load mutual funds. In view of the growth of these funds in recent years it is evident that the public has found them useful. The Exchange, therefore, urges that it would be preferable to regulate any areas of real or potential abuse rather than abolishing this investment media.

MUTUAL FUND HOLDING COMPANIES

Proposed Section 7 of the bill would repeal present sections of the 1940 Act which permit, within certain limits, the purchase of shares of an investment company by a registered investment company. It would prohibit in all instances the purchase by a registered investment company of shares of another investment company and would likewise prohibit the purchase by any investment company of shares of any registered investment company. It also would prohibit brokers or dealers in securities, registered investment companies or their principal underwriters from knowingly selling any share of a registered investment company to any investment company.

Here again, we would question whether the remedy suggested is not more drastic than is necessary. Section 7 goes too far in precluding ownership by investment companies of shares of other investment companies. For example, it would prevent one registered closed end investment company from purchasing any shares in another closed end fund. It also seems to us to be an unfair and unenforceable burden to require brokers and dealers to be the instrument of enforcement with respect to the sale of registered investment company shares to an investment company outside the jurisdiction of the SEC.

The Exchange urges that restrictions on broker-dealers be eliminated and that a workable framework of regulation be established to prevent any specific abuses which may be created by one fund holding shares of other funds, rather than to abolish this particular form of investment media.

AGENCY RULE-MAKING AND CONGRESSIONAL PREROGATIVES

Finally, it is our feeling that many of the individual provisions in these bills give those in the securities business legitimate cause for concern. It is our impression that many of the proposals give the SEC the broadest type of rule-making authority which, in effect, results in the delegation by Congress of its legislative functions to a Federal administration agency. It is our feeling that it is preferable to draft such provisions along the lines of Section 16 of the Securities Exchange Act of 1934 and to set our specific requirements that must be met rather than to grant vague, broad, rule-making authorization to the SEC.

CONCLUSION

The New York Stock Exchange is not, and has not been opposed to regulation of the securities industry. We spend much of our time and energy in regulating the activities of our members and their employees. We have long recognized the wisdom of Congress in enacting the Federal securities acts and the benefits to the public that have resulted therefrom. But we do believe that additional legislation should not be adopted except to meet a clearly demonstrated need and that whatever legislation is adopted should be practicable and workable.

The legislation before this Committee promises to set down the legislative guidelines which will be controlling for many years. We agree wholeheartedly with the SEC that the investment companies have been useful and desirable for investors, but we feel that the documentation—and lack of it—in the Com-

mission's position leaves much to be resolved. We are impressed, as always, by the careful consideration this Committee is giving as it moves to make its determination of these matters. We respectfully urge that the changes made by the Committee in H.R. 9510 and H.R. 9511 be consistent with the reservations and recommendations suggested above.

Mr. HAACK. My name is Robert W. Haack. I am president of the New York Stock Exchange. With me here today to present the views of the exchange on the proposed amendments to the Investment Company Act of 1940 which are incorporated in H.R. 9510 and H.R. 9511 are Gustave L. Levy, chairman of the exchange's board of governors, and Donald L. Calvin, a vice president of the exchange.

Our purpose in appearing before the subcommittee is to present the views of the exchange on the major proposals in this legislation. Mutual fund shares are not listed on our exchange and our board of governors has no self-regulatory responsibilities under the Investment Company Act of 1940. Nevertheless, the exchange does have an interest in these proposals because mutual funds currently account for approximately 10 percent of all trading on the exchange and own an estimated 5 percent of all stocks listed thereon. Further, the exchange's member firms account for approximately 40 percent of all sales of mutual funds to the public and hence could be affected directly and substantially by the proposed legislation.

We believe that the regulatory framework established by the Congress in the Investment Company Act of 1940 has worked well. This does not mean to say that changes cannot be made in the act to increase the protection of the investing public. The exchange's review of the bills before the subcommittee, however, raises a number of questions as to the potential impact on both the investing public and the securities industry of the changes that are recommended in the existing regulatory scheme. We are concerned with the thrust of some of the proposals for two very basic reasons:

First, no mechanism is provided for the self-regulatory processes which are well established in the securities industry. It is our opinion that industry self-regulation should play an important and positive role in the industry.

Second, little justification is given for many of the proposals in either the SEC's report on investment companies or in its testimony and supplemental analyses of the bills.

The exchange's specific comments on the four major proposals in the bills are as follows:

LIMITATION ON SALES CHARGES

The exchange is of the view that maximum reliance should be placed on self-regulatory procedures in the area of sales charges.

It is our experience that nowhere in the world is the investing public better served—and protected—than in this country. The self-regulatory agencies and exchanges within the securities business have demonstrated that they can be flexible and responsive to changing conditions.

It is in the public interest that self-regulation be continued, and that this concept be embodied in the bills before this subcommittee.

The Commission's proposals relating to sales charges represent a sharp departure from the concept of self-regulation. Rather than seeking to strengthen self-regulation, the Commission asks for a statutory maximum on mutual fund sales charges of 5 percent of the net asset value of shares purchased. Further, the SEC asks that it be granted the sole authority to increase or change the maximum.

The exchange suggests that this proposal be rejected for the following three reasons:

First, no meaningful justification has been given by the Commission as to why self-regulation cannot be made to work in this area. Why SEC ratemaking authority is preferable also is a wholly unsupported concept.

Second, the Commission makes no showing that the investment fund industry is in fact a public utility and, hence, must have its rates regulated by a governmental agency.

Third, nowhere in the Commission's report is there evidence that it made any detailed analysis of the economic consequences of a 5-percent maximum. The report provides no estimate of the effect of the lower revenues on sales, on the services which funds provide customers, on profitability, or on the number of firms that might become so unprofitable as to be forced to leave the business. Certain industry studies indicate that the unfavorable impact on the industry and its customers would be enormous.

For these reasons, then, we oppose the SEC's proposal to set a 5-percent limit and strongly endorse the approach of strengthening self-regulation in the area of mutual fund sales charges.

We recognize that a number of problems remain to be resolved if the self-regulatory approach is to be followed. The NASD would be the most appropriate organization to be given this self-regulatory responsibility. We also support the NASD approach that the association initiate the necessary studies to develop effective guidelines for mutual fund sales charges. We are aware that problems exist with respect to the regulation of sales charges for broker-dealers that are not members of the NASD. While these problems are complex, we think that they can be resolved and that self-regulation can be made to work in this area.

MANAGEMENT FEES

Proposed section 8 of the bill would establish an entirely new standard in the law to give the SEC indirect ratemaking authority over management fees. This authority would replace the basic corporate concepts of authority, responsibility, and accountability of directors, and ought to be rejected for the following four reasons:

First, the bill suggests that new concepts be introduced in our securities laws, existing law be repealed, and numerous State court cases be overturned. It is appropriate to inquire, therefore, how this new concept will be superior to present law, and how it would improve the protection for fund investors.

Second, proposed section 8 of the bill places the task of determining whether a fee is, in fact, reasonable under the statutory standard on the courts. The adoption of the SEC approach could lead to a rash of legal suits against funds, investment advisers, and directors and

officers, as it appears that this would be the only way under this section to determine whether the fee is reasonable.

Third, the SEC approach of "ad hoc ratemaking by litigation" may well be regarded as a lawyer's delight. It could work to the detriment of mutual fund shareholders, however, by stimulating burdensome and costly litigation, and making it increasingly difficult for the industry to find men of stature and independence to serve as directors.

Fourth, there appears to be little basis for the implication that fund directors and shareholders are not fully competent to determine what fees and salaries are reasonable for investment advice and that this decision must be made for them by the courts.

It seems evident, therefore, that the present statutory approach is far superior to the SEC proposal. Reliance in present law is placed in the judgment of directors of investment companies and their shareholders. This requires that the board of directors of the fund perform functions akin to those in any other business entity and to be held to the same standards of conduct. If changes are to be made in this area, the exchange would suggest that the role of the nonaffiliated director be strengthened.

We think this approach minimizes any risk there may be to the public interest in this area and ought to be seriously considered in lieu of the proposal made in section 8.

CONTRACTUAL PLANS

In another proposal, the Commission urges the abolition of contractual or front-end load mutual funds.

While the Commission asserts that the front-end load imposes an undue burden on investors, we would question whether it is necessary to abolish this investment media. The exchange takes the position that, rather than abolish contractual plans, any areas of real or potential abuse should be regulated and, possibly, a rebate policy should be instituted for certain early terminations involving hardship.

MUTUAL FUND HOLDING COMPANIES

Proposed section 7 of the bill would repeal present sections of the 1940 act which permit, within certain limits, the purchase of shares of an investment company by a registered investment company. It also would prohibit brokers or dealers in securities, registered investment companies or their principal underwriters, from knowingly selling shares of a registered investment company to any investment company.

It is the exchange's position that it is an unfair and possibly an impossible burden to require brokers and dealers to be the instrument of enforcement with respect to the sale of registered investment company shares to an investment company outside the jurisdiction of the SEC.

In the agreements which have been reached between the SEC and the Investment Company Institute, as outlined in the exhibit filed by the Chairman, of the SEC on October 10, there is, to be sure, some easing of the restrictions that would be imposed by section 7. Paragraph (1) (B) still seems to create a problem since the language makes

it, among other things, unlawful for any registered broker or dealer "knowingly to sell . . . any security issued by" a registered open-end investment company to any other investment company. This language might be construed as requiring a selling broker or dealer to discover the identity of the buying broker or dealer's customer in order that the selling broker or dealer can be sure he is not violating the law. Any such condition would impose an impossible burden on the selling broker or dealer.

Therefore, the exchange urges that the restrictions on broker-dealers be eliminated and that a workable regulatory framework be established to prevent any specific abuses which may be created by one fund holding the shares of other funds.

CONCLUSION

In the preceding comments we have discussed only four provisions of H.R. 9510 and H.R. 9511. In brief, we have urged the following alternatives to the Commission's proposals in these areas:

1. Sales charges. The exchange strongly endorses the approach of strengthening self-regulation in this area.
2. Management fees. The exchange opposes present section 8 of the bills and suggests that if changes are to be made that the role of the nonaffiliated director be strengthened.
3. Contractual plans. The exchange recommends that contractual plan or front-end load mutual funds not be abolished, but that any areas of real or potential abuse be regulated and possibly that a rebate policy should be instituted for certain early terminations involving hardship.
4. Mutual fund holding companies. The exchange recommends that a workable framework of regulation be established to prevent any specific abuses which may be created by one fund holding stocks of other funds and that the proposed restrictions on brokers and dealers with respect to the sale of mutual fund shares to a fund holding company be eliminated.

The legislation before this subcommittee promises to set down the legislative guidelines which will be controlling for many years. It is the exchange's position that additional legislation should not be adopted except to meet a clearly demonstrated need and that whatever legislation is adopted should be practicable and workable. The exchange agrees wholeheartedly with the SEC that the investment companies have been useful and desirable for investors, but we feel that the documentation—and lack of it—in the Commission's position leaves much to be resolved.

In conclusion, the exchange respectfully urges that the changes made by the subcommittee on H.R. 9510 and H.R. 9511 be consistent with the reservations and recommendations suggested above.

Thank you.

Mr. Moss. Thank you.

Do either of you other gentlemen have a statement?

Mr. LEVY. No, sir.

Mr. CALVIN. No, we do not.

Mr. Moss. Thank you.

Mr. Haack, is there any significance to the difference in phrasing in the statement which was originally filed, and the statement which you have just given, as it relates to the recommendations contained under the subheading "Management Fees," beginning on page 4 of the statement you have just read, and also I believe on page 5 of the statement you have just read and 4 of the statement which you have previously submitted?

The statement that you have previously submitted contains this phrasing:

We understand that the Investment Company Institute has indicated to the SEC its willingness to go beyond the present concept. As we understand that proposal, it contained three important points. First, the number of independent directors would be increased from 40 percent to a majority. Second, the independent directors of the fund would be required to make a specific finding in the exercise of business judgment, that a proposed management fee contract is reasonable. Third and final, a fund shareholder could commence an action in a federal court to recover on behalf of the mutual fund any portion of a management fee which the court found was unreasonable. In such an action, the court could upset a management fee contract upon the finding that the approval by the directors was an abuse of business judgment.

We think that this proposal minimizes any risk there may be to the public interest in this area and ought to be adopted.

The language on page 5 which you have just read would appear to modify that substantively. Is that the intent?

Mr. HAACK. No.

Mr. MOSS. It is not?

Mr. HAACK. It is not. This is in our judgment a cut-down version, an abbreviated version.

Mr. MOSS. I just wanted to be quite clear.

Mr. HAACK. Yes.

Mr. MOSS. In the record.

Mr. HAACK. Yes.

Mr. MOSS. Now, one of the matters which the SEC has criticized is that of the use of exchange brokerage or give-ups to the compensation of dealers handling mutual fund shares. What is the position of the exchange on this issue?

Mr. HAACK. This is a matter which is presently being discussed by our Cost and Revenue Committee, and the exchange has not come out with any official pronouncement on it.

If I can give a personal opinion, it would seem to me that the sharing of commissions violates no good, sound business concept, that it results in no extra cost to the buying fund, and as a matter of fact you can make some very excellent reasons for justifying the concept of the lead broker in that it involves giving an order to only one fund instead of four or five or eight or 10 funds, eight or 10 brokers.

As far as the bestowing of reciprocal business on brokers, it seems to me that this is not a reprehensible practice in this country. Reciprocity has been defined as doing business with those who do business with you. It seems to me there is no trouble in this area except in the possibility of abuse, where an incentive might be unduly large, so as to influence the judgment or the recommendation of the salesman.

I think that this is subject to types and degrees of surveillance by the SEC and by the NASD which has the authority to regulate sales compensation.

I think it in concept and in principle is perfectly all right and justifiable. The abuses, as I say, can be controlled and corrected.

Mr. MOSS. In other words, your answer anticipates the following two questions: Can the exchange handle the matter? Your answer would be yes, it can.

Mr. HAACK. I think that the exchange in concert with the NASD could very well do this. As a matter of fact, I understand that my former associates at the NASD are presently addressing themselves to this very problem.

Mr. MOSS. And then does the SEC have the authority to direct regulation in this regard?

Mr. HAACK. I would say yes, under 19(b) they certainly would have control.

Mr. MOSS. The answer, however, just given by you as to policy represents an individual view and not at this moment the position of the exchange.

Mr. HAACK. That is right. There are a number who would support me, Gus, do you want to speak to this?

Mr. LEVY. I agree with Mr. Haack, Mr. Chairman, 100 percent. My personal position again is that the mere execution of an order is just one part of the commission. There is lots more that goes into the earning of the commission than the execution. Therefore, I personally believe in the give-up system. I believe in reciprocity. Reciprocity is a part of the American way of life.

Mr. MOSS. But again we have no official position.

Mr. LEVY. Not as yet.

Mr. MOSS. By the exchange.

Mr. HAACK. Not as yet.

Mr. MOSS. Another matter which the SEC mutual fund report considers is that of the portfolio commissions paid by the various funds. It appears that there have been certain questions, and in some instances lawsuits, regarding the management securing its portfolio at the lowest possible cost. I believe this has led to suggestions either that the third market be used or that the stock exchange have lower rates on larger blocs of shares. What is the exchange's viewpoint on this matter of commissions? Or has it developed?

Mr. HAACK. We are presently addressing ourselves to this problem. Instead of a commission based on the number of shares involved, we are addressing ourselves to a study of a concept involving the amount of money involved. This would in effect give some kind of a volume discount to the larger buyer or seller.

One of the problems, however, is to make sure that the volume of brokerage commissions is not substantially damaged, because if you reduce commissions at the large end of the spectrum, the question is the possibility or advisability or feasibility of raising this in other areas which in turn might throw an unwarranted burden on the smaller investor.

Mr. MOSS. What authority does the SEC have in this?

Mr. HAACK. Similarly under 19(b) of the 1934 act, they could institute proceedings to accomplish their objective.

Mr. MOSS. In the letter which this committee received at the end of August from the then President Funston, it was indicated that a sub-

stantial portion of the tremendous market turnover this past spring and summer was attributable to the activities of institutions, including the investment companies. What is your position with respect to the influence on a free and open market of these transactions of investment companies.

First, those companies whose policy it is to turn over their portfolio, and secondly, the other companies who have substantial blocks which either are held out of the supply of the market or from time to time are sold through the market?

(The following correspondence referred to above was submitted for the record by the committee:)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., August 3, 1967.

Mr. G. KEITH FUNSTON,
President, New York Stock Exchange, New York, N.Y.

DEAR MR. FUNSTON: One cannot but note that yesterday 13,510,000 shares were traded on the New York Stock Exchange following 12,290,000 on Tuesday, and 6,546,000 shares were traded on the American Stock Exchange following 6,108,000 on Tuesday, and also that the total volume of shares to date on the New York Stock Exchange has been 1,476 million shares compared with 1,176 million in 1966 and 802 million in 1965 to the same date, and the total volume of sales to date on the American Stock Exchange is 620 million compared with 489 million in 1966 and 261 million in 1965 to date.

In such connection, I am mindful of your testimony before our Subcommittee on Commerce and Finance on June 29, 1961 on H.J. Res. 438, a resolution directing the Securities and Exchange Commission to conduct a study of the adequacy, for the protection of investors, of the roles of national securities exchanges and national securities associations. At the time you expressed concern over the activity in the markets which then existed.

I am writing you in the thought that you might indicate to me just what is going on now in the stock markets which gives rise to this tremendous and increased volume of transactions and how the situation now may differ from that of six years ago.

You may also wish, in view of the pendency of the end of your term as head of the exchange, to utilize this opportunity to give some accounting of your stewardship by setting out the steps which have been taken by the exchange during these past six years to strengthen the protection afforded to investors.

With continuing good wishes to you in your new undertaking.
Sincerely yours,

HARLEY O. STAGGERS,
Chairman.

NEW YORK STOCK EXCHANGE,
New York, N.Y., August 23, 1967.

HON. HARLEY O. STAGGERS,
Congress of the United States,
Committee on Interstate and Foreign Commerce,
Rayburn House Office Building,
Washington, D.C.

DEAR CHAIRMAN STAGGERS: I am pleased to reply to your letter of August 3, in which you ask my views on the reasons for today's heavy volume on the New York Stock Exchange and offer me the opportunity to discuss measures taken by the Exchange to provide increased protection for investors during the past six years. I would like to discuss these two distinct and extensive subjects separately.

SOURCES OF TODAY'S EXCHANGE VOLUME AND COMPARISONS WITH 1961

Average daily volume for the first seven months of the year was 9.9 million shares compared with 4.1 million shares in 1961, a gain of over 100%. The Ameri-

can economy, of course, also grew substantially over the same interval. Gross National Product rose almost 50%—from \$520 billion to its present \$775 billion; annual personal savings are 80% higher; corporate profits after taxes are up about 70%. The number of shareowners has risen by 42%—from an estimated 15.5 million in 1961 to the present 22 million. Financial institutions making broad use of the stock market, such as mutual funds and pension funds, have enjoyed particularly strong gains. These factors plus the fact that the economy was able to move ahead without recession in unprecedented fashion all have had their impact on Stock Exchange volume.

All the major groups who use the stock market have increased their activity over the past six years. The table below shows the results of two Public Transaction Studies which can be used to compare the volume attributable to public individuals, institutions and New York Stock Exchange members themselves in 1961 and 1966.

MAJOR SOURCES OF NYSE VOLUME—SHARES BOUGHT AND SOLD IN ROUND LOTS AND ODD LOTS, 1961 AND 1966¹
[Shares in millions]

	1961		1966		Percent growth
	Shares	Percent	Shares	Percent	
Public individuals.....	3.8	51.4	6.1	43.2	60.5
Institutions and intermediaries.....	1.9	26.2	4.6	32.5	142.1
NYSE members.....	1.7	22.4	3.4	24.3	100.0
Total.....	7.4	100.0	14.1	100.0	90.5

¹ "NYSE Public Transaction Studies," Sept. 13, 1961, and Oct. 19, 1966.

The Public Transaction Studies indicate that financial institutions and intermediaries have led the way toward expanded volume on the Exchange. The data on large blocks, the SEC's statistics on institutional transactions and analyses of the reports of institutions themselves confirm this finding.

The latest information released by the SEC, covering the first quarter of 1967, indicates that the four major groups of institutions bought and sold \$10.4 billion of common stock in all markets, about three times the quarterly average in 1961. Even more dramatic is the sharp climb in the turnover of institutional portfolios. In the first quarter of this year, the turnover ratio (transactions divided by holdings) reached almost 24%, in contrast to about 15% in recent years. Mutual funds have increased their turnover to 41%, against 19% as recently as 1964. Individual mutual funds—particularly the so-called performance funds—are thought to have even higher turnover rates.

Judging from current figures on odd-lot trading and new account openings, non-professional market participants have not expanded their relative share of activity in the NYSE market during 1967, nor have they been purchasing on balance. This is confirmed by reports from our member organizations, showing that the larger part of our volume attributable to individuals is now coming from the higher-income, better-educated, and more knowledgeable segment of the investing public. This contrasts with conditions in 1961, when the Exchange felt required to caution the public on the unrealistic attitudes prevalent among some investors.

While the share volume in 1967 has been at record levels, it is not unprecedented in terms of the turnover in shares listed. This year's pace of 22% is about what it was in the post-war years of 1946 and 1950. In 1961 the turnover rate was 15%. From the turnover viewpoint, today's volume can be considered as catching up to the marked growth in the past six years in the number of securities listed on the Exchange. At the beginning of 1961 there were 1,143 companies and 6.5 billion shares listed, compared with the current total of 1,277 companies and 11.3 billion shares.

None of these influences in the market is really new. As emphasis has shifted among different groups of investors and different groups of securities, the Exchange's continuing research and surveillance activities have enabled us to keep abreast of changing trends.

For example, the Exchange's planning and development studies made over the past ten years did not indicate that present volume levels would be reached until the mid-1970's. The Exchange nonetheless pushed ahead with physical and operational improvements to handle much larger volume than was expected during any given year. Thus, we introduced the high-speed ticker in 1964, the computer center in late 1965, and have been continuing to work at automating the trading floor, odd-lot switching, certificate clearance, and back office procedures. These steps have enabled the Exchange itself to cope with the upsurge in activity without any serious problems in the marketplace.

In summary, I think the increase in volume experienced over the past year is primarily attributable to institutional and other professional activity and does not at this time suggest a return of the conditions with which I was concerned in 1961.

STEPS TAKEN SINCE 1961 TO FURTHER INVESTOR PROTECTION

The Exchange continually assesses its programs and procedures to insure that we are doing all we can to provide a climate of security for investors. I am finishing my tenure as President with the knowledge that the Exchange in these years has been highly responsive to the interests of investors in a great many small ways and some very large ones. It would be impracticable to enumerate all the steps taken during even the past six years and an attempt to do so would surely tax your reading patience. Consequently, may I remark on some of the major developments and offer examples of our more or less everyday progress. For convenience, I am dividing my review by the titles of the Exchange departments which are primarily concerned with procedures designed to benefit investors.

1. *Department of Member Firms*

This department administers most of the Exchange rules and policies affecting member brokerage firms, their principals and their employees among whom, of course, are the registered representatives who deal directly with the public. Obviously, any effective program must be centered on the organizations and personnel which advise the public, execute its orders, and handle its funds and securities.

When I appeared before your Committee in 1961, we were in the process of revising our written registered representative examination program to maintain high standards of quality as the number of individuals entering the industry mushroomed. I think this program has proved successful. Since 1961 we have instituted new written examinations for branch office managers and supervisory security analysts. In addition, we ended a practice of over 100 years' standing by supplementing the oral interviews of new Exchange members and allied members with a comprehensive written examination. All these examinations are continually being upgraded in an attempt to maintain high standards of performance for member organization personnel.

Shortly after I met with your Committee, we established a formal program whereby Exchange staff personnel spot-check the supervisory practices of some 3,700 branch and main sales offices at least every third year. This step was accompanied by a program designed to encourage member firms to put increased emphasis on the selection, training and supervision of sales personnel. This intensified attention to the performance of supervisory personnel and the training of registered representatives is, I believe, one of the most significant developments of the last six years for the protection of the investing public.

We now utilize computers in our "stock watching program," which is designed to inform us daily of significant changes in price-volume and concentrations of activity in individual stocks. A review is made of each such security and of any other security which may warrant attention to learn why such activity has occurred. The object of this program is to permit the Exchange to satisfy itself that a fair and orderly market is being maintained. We work closely with the SEC in this program.

In addition to administering rules and policies, the Exchange instructs member organizations in ethical standards of conduct towards customers and sponsors conferences throughout the country to spread this message as widely as possible among member organization personnel. I am enclosing a copy of our "Ethical Conduct Study Guide."

The high level of financial responsibility of our member organizations, which has been outstanding on a worldwide basis for many years, was expanded in 1964 by the establishment of a special trust fund program totaling \$25 million. The Trustees of the special trust fund, with assets of over \$10 million, may, in their discretion, assist customers of any member organization who may be threatened with loss of their funds or securities because of the financial condition or insolvency of the member organization. The establishment of this program followed the remarkable action of the Exchange community in providing \$9.5 million to assist the customers of the Exchange community in its failure. Another change arising from this experience was a tightening in several ways of our barriers against the possible influence of commodities losses on securities customers. The Board of Governors in late 1960 deposited approximately \$800,000 to assist the customers of du Pont, Homsey & Company when that firm went into receivership. In January 1961, the Exchange adopted an expanded mandatory fidelity insurance program for member organizations. Probably the most significant aspect of this program is that it provides for coverage of general partners of member firms. Previously, fidelity insurance covering general partners had not been generally available. In March 1961, the Exchange itself took out "excess" fidelity bonds totaling \$10,000,000, which would come into play should the resources of a member organization and its general partners become exhausted as a result of a fraudulent or dishonest act.

Also significant was the enactment of a rule requiring member organizations to send at least a quarterly statement to all customers who have any money or security balance in the custody of the firm during the preceding period. Most firms voluntarily sent monthly statements before the rule was enacted, but the rule ensured that all customers would be furnished this information. Previously, member organizations were required to send such a statement only at the time of an annual audit.

Investors were further benefited recently when the Exchange permitted members brokers to offer life insurance on customers' debit balances in margin accounts.

The Exchange just enacted a rule requiring member organizations to show on customers' statements the rates and amount of interest charged on debit balances. This voluntary step provides the type of disclosure which would be required under the "truth in lending" legislation presently before the Congress.

There is one area, however, where progress has not been satisfactory, although we have tried to bring about reforms. I refer to the "unregulated lender" who can finance securities transactions unhampered by Regulations T and U of the Federal Reserve System. You will recall my testimony in 1961 indicated the concern with which we viewed the unhealthy effect on securities markets this unregulated lending can have. Regrettably, little has been accomplished as the Board of Governors of the Federal Reserve System seems to think the unregulated lender is not as significant a part of the securities credit system as we do. You may have noted recent press comment on the unregulated lender or "factor," who has become more active as current market levels attract persons desiring the high leverage this type of credit affords. As I am sure you know, the SEC Special Study also highlighted this practice, recommending that restraint be placed upon such lenders. As the enclosed circulars state, member organizations may not assist customers in arranging credit from these lenders contrary to Regulation T. However, this is an area where we believe further action at the Federal level is still required.

2. Advertising Department

This department regulates Exchange standards for member organization communications with the public and formulates the Exchange's own national advertising program.

In September 1963, we significantly strengthened and expanded our already substantial rules governing advertising, sales literature, market letters, research reports, writing and speaking activities. A copy of these rules is enclosed. In particular we expanded the regulation of research activities, of promotion of past recommendations, of the use of testimonials, disclosure, identification of sources and portfolio analysis. A system of spot-checking our disclosure requirements and the possibility of trading against recommendations was instituted. In 1962, for example, the Exchange staff reviewed 6,000 pages of member firm investment literature. In 1966, more than 25,000 pages of this material was reviewed.

Over and above adding new rules, a great deal was done in our public programs. We put greater emphasis on educating the public about investing and pointing out the risks as well as the rewards. From time to time, as conditions warranted, we warned the public about speculation and the need to follow sound investment practices. In our 1961 advertising campaign the Exchange stressed rules for the wise investor. I am enclosing a booklet which discusses the difference between a broker and a tipster and the dangers that can result from heeding tips and rumors. A special campaign devoted to informing the public of Exchange regulations designed to protect investors was run in the Fall of 1962. This theme was continued in the Spring of 1963 in a new series of clear and factual ads. Part of our 1964 advertising was devoted to educating the public about the basic workings of the New York Stock Exchange. This was in addition to cautionary statements which appear in virtually all Exchange ads, in one form or another. Sample copies are enclosed.

3. *The Department of Stock List*

Rules and procedures affecting companies listed on the Exchange are administered by this department. Many investors—both individual and institutional—limit their holdings to companies listed on the New York Stock Exchange because of the hallmark of quality implied in a listing.

To maintain this confidence, the Exchange, among other steps, has increased its standards of eligibility for original listing and criteria for delisting three times since 1961. Applicants for listing must meet increased requirements for past annual earnings, share distribution, and related items. As the general level of the economy has risen, these requirements have been stiffened to ensure that a company applying for listing on the New York Stock Exchange has an exemplary operations record and sufficient distribution of its securities to provide a market in depth.

Our delisting criteria today are approximately 40% of our original listing requirements and are generally more stringent than the original listing standards of any other national securities exchange.

To prevent rumors and misinformation from influencing market activity, we have strengthened our policy requiring listed companies to disclose in a timely manner events which may affect investment decisions or securities values. This policy, spelled out in a 1960 letter from me to the presidents of all listed companies, has resulted in a more careful observance and regard for this objective.

In the same vein, new methods of handling the public release of information by government agencies have been developed, to prevent individuals from capitalizing on advance information regarding contract awards, important regulatory decisions and the like.

Proper conduct by officers and directors of listed companies is important for the protection of investors. In November 1965 we published a booklet, "The Corporate Director and the Investing Public," outlining Exchange policies concerning outside directors, ethical conduct, conflict of interests and other problems which affect investors' security. Over 50,000 copies have been distributed, and it has been widely acclaimed as an important contribution in the area of proper corporate conduct. I am enclosing a copy of this booklet.

We have been successful in obtaining further investor safeguards through such means as requiring newly listed companies to report to stockholders on a quarterly basis, and to include a source and application of funds statement as well as comparative financial statements in their annual reports.

We continually urge listed companies to include outside directors on their boards. Companies applying for a listing are urged to elect at least two outside directors to their boards within a reasonable time after listing. While precise figures are not available, as of 1961 we estimate that 60 companies did not then follow this practice, while today only about 15 companies have no outside directors.

4. *The Floor Department*

The Floor Department is responsible for the administration, interpretation, surveillance and enforcement of the Exchange rules and policies relating to the overall operations on the Floor including the functioning of the auction market, the handling of orders and reports, and the publication of transactions. It also conducts the examination, registration, and surveillance of specialists, registered

traders, odd-lot brokers, and processes all complaints, requests for information and general correspondence relating to any of these areas.

The period since 1961 has witnessed the introduction of the most modern automated data processing techniques and a nearly three-fold increase in The Floor Department's personnel devoted to its surveillance work. The procedures, policies and rules of The Floor Department have undergone certain significant innovations and modifications in order to keep abreast of expanding economic and market conditions. It is felt that the representative new procedures outlined below, which have been enacted in accordance with our policy of continually endeavoring to upgrade the quality of the market, have been of substantial benefit to the investor and greatly strengthened the protection afforded to him.

To ensure the financial responsibility of all specialist units in today's larger markets, each unit must now be able to assume a position of 2,000 shares in each specialty stock. Each unit's financial condition is checked regularly as well as after any significant market decline. Greater financial flexibility has been provided for in the event of unusual market situations. An emergency committee has been established and is authorized immediately to reallocate stocks should the necessity arise.

In seeking to maintain, insofar as reasonably practicable, a fair and orderly, as well as the most liquid securities auction market, modifications have been made with respect to the general criteria for market maintenance by the specialist. Specialists' dealings and stabilization rates have been subjected to higher standards. In addition, standards of depth and price continuity have been substantially increased. New amendments to our rules now set forth more clearly that specialists' actions in establishing, increasing, liquidating or reducing positions must be consistent with their market making function. Moreover, a comprehensive written examination is now required of all applicants for specialists' registration.

One of our most significant advances made in the area of surveillance utilizes a computer to produce a monthly market study which flags for possible review a specialist's actual market performance in each 100 share unit common stock. Also, real-time automated price surveillance is now a fact, and price movements outside certain pre-set limits are automatically printed-out by the computer, thus alerting us to unusual situations as they develop. Exchange automation has made possible the daily printing of a Transaction Journal, which now provides the time, tick and price variations of all transactions and quotations reported in the Market Data System. This provides quick, complete, and immediately accessible data for review and surveillance on an overnight basis. Through these surveillance and review procedures, we are able to note quickly abnormal price movements or possible rule infractions.

In 1966, the odd-lot differential schedule was amended in favor of the "small investor" who places orders for less than 100 shares. The differential is now $\frac{1}{8}$ of a point on issues selling up to \$55 per share as compared with the previous "cut off" level which was \$40 per share. A differential of $\frac{1}{4}$ of a point is applicable for issues priced at \$55 or above.

Although investigative activities have always been conducted by the Floor Department, a formal Investigation Division has been created to enable the Exchange to provide complete and prompt investigation into any questionable activities occurring on the Floor. In carrying out its self-regulatory role, any indication of a rule infraction—whether it is brought to our attention through our extensive surveillance procedures, by a Governor or member on the Floor, or through a public customer—is thoroughly investigated. When the facts disclose an actual violation, the case is carried to a conclusion under the applicable disciplinary procedures of the Exchange. If a public letter contains a complaint or inquiry, a complete answer is given and an investigation conducted, if the facts so warrant.

In 1963, our accountant-examiners began conducting annual surprise reviews of the back office records of specialists and registered traders. They also engage in any special investigative projects which may seem appropriate in the light of overall surveillance objectives.

Conclusion

I realize this letter is lengthy, and I ask your forbearance. However I am proud of our efforts to make certain that the public can invest in our market with

confidence and safety, and I appreciate the opportunity to summarize some of the measures we use.

I would like to thank you for the courtesy you have shown me and members of the Exchange staff during the sixteen years of my presidency. I like to think that during these years the Exchange and those concerned with our securities markets in Congress have been effective partners in proposing programs designed to prohibit practices harmful to the investing public. I know my successor, Mr. Robert W. Haack, will continue this policy.

Sincerely,

G. KEITH FUNSTON,
President.

Mr. HAACK. This is a valid concern and one again which we are addressing. The advent of the institutional customer has been a phenomenon that has been developing over a number of years. It would appear roughly that institutional volume at our exchange at the moment accounts for about 32 to 33 or 34 percent of our total volume. The indications are that this some time in the next decade might become as high as 50 percent.

This raises some interesting philosophical and also practical questions as to what effect this phenomenon has on the marketplace and the resilience of the exchange to adapt itself to this problem.

We have made several studies to determine the impact pricewise of activities of institutional holders. We, in 1962, came up with the conclusion that the funds on balance were a stabilizing force in the marketplace. At this point, our most recent study was made the latter part of 1966, and again we have come to the conclusion that the effects, except for a long-term basis, are not of great consequence.

The ability of the exchange to adapt itself to this phenomenon I think has been interesting. For example, in the third quarter of 1966 there were approximately 900 block transactions involving amounts of stock in excess of 10,000 shares. The third quarter of this year shows about a 100-percent increase in this, in that there were approximately 1,735 block transactions involving transactions of more than 10,000 shares, and totaling some 42 million shares.

Now, we tried to break this down, and we made a sample of 200 of those transactions. We found out that approximately one-half were affected at price fluctuations within a quarter of a point plus or minus of the preceding sale. We found out that two-thirds of these 200 sample transactions resulted in fluctuations of a half a point up or down from the prior sale.

This I think speaks amazingly well of the specialist system, the financial ability, the willingness of these people to make markets and to accommodate the exchange to the increased activity of the institutional buyers and sellers.

So far as the activity of these people is concerned, I would submit that our only control of them is through the broker-dealer, that we are not able under any authority to question the motivation of these people; whether they are speculatively inclined or investment minded is something that we are concerned with but we do not have jurisdiction or control over their motivations. We try to make certain that the marketplace functions, that price discrepancies and variations are minimal. We have a stock watch system which addresses itself to that very problem, and there are occasions when we do go behind transactions as far as possible.

Frankly, one of the amazing things to me is the resilience that the floor of the exchanges have shown to this fantastic development of the last several years.

Mr. MOSS. Thank you. Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman.

I think we, too, on this committee have been amazed at the ability of the market to handle these tremendous sales. You have just referred to this as a fantastic development. It makes me wonder whether or not further interest on the part of Congress to this fantastic development is necessary. Do you have sufficient authority in the exchange to expose to the light of day these activities that thus far you have been able to live with? Are you concerned about the continued spiraling or acceleration of the institutional buying to the extent that you feel that perhaps some kind of study should be made either by the SEC or by the industry, or by the institutions, or by all three?

Mr. HAACK. Well, I would say, first of all, that any additional information or light that is thrown on any problem area is most welcome and, absent it, you and the SEC and the self regulators are operating in a vacuum. I don't feel that the need is particularly urgent at this time.

So far as our concern of this spiral is involved, I think it imposes on us some obligations to make certain that our specialist system is well financed. As a matter of fact I have on my desk at the moment a proposal involving a credit bank for specialists, which would increase their already substantial financial abilities.

One thing that does concern me, and this again is a personal point of view, is the increased reliance of the investment industry on institutional activity for profitability. I remember some 25 years ago, when I started in the business, a lot of firms got the majority of their income from the relatively small investor. Now everybody is looking for the big ticket. You want to call on an insurance company or a mutual fund. The question in my mind is whether or not the funds are becoming so important to firms and to individual salesmen that there is a tendency to give shorter shrift to the individual investor, which I think works to the detriment of everything that we are striving for.

The individual investor has been the bulwark of the auction market, and I again remember not so long ago when a specialist book would have many bids and offers up and down from the present marketplace. That is not always the case today. And absent that public investor, there is a greater burden put on the specialist, and this I think stems from the greater reliance for profitability on institutions.

I think it ties in with the problem that any action taken in this legislation that would further curtail the economic incentive for broker-dealers to contact the individual investor undoubtedly re-ounds to the detriment of the whole system, and that is a personal point of view, but I would subscribe to it.

Mr. STUCKEY. Would the gentleman yield for a minute?

Mr. KEITH. Yes.

Mr. STUCKEY. Are you saying then that using the specialist system has not worked well?

Mr. HAACK. Oh, to the contrary; it is working amazingly well.

Mr. STUCKEY. With or without mutual funds or institutional investment?

Mr. HAACK. I would say under either circumstance, but particularly well in light of the increased activity of funds.

Mr. STUCKEY. So then you are saying that you feel that the specialist has been effective in helping to control the market.

Mr. HAACK. Very much so.

Mr. LEVY. May I say what Mr. Haack meant to imply? In the old days there used to be a lot of orders up and down, buy and sell, in the book. Today the dealer has to be more of a specialist than ever before.

Mr. STUCKEY. And he has handled this responsibility quite well.

Mr. LEVY. Yes, sir.

Mr. HAACK. But my point is that as it becomes increasingly attractive economically for a salesman to focus on the larger customer, there is less time in his day to service the investment needs of the smaller purchaser who has been the backbone of the entire stock-ownership program in this country.

Mr. KEITH. I think it might be interesting for you to know the results of some mail that I received on the subject of the proposals of the SEC. In particular I was impressed by men who had been broker-dealers calling on the small accounts that up until recently have been the lifeblood of the brokerage firms throughout the country.

This fellow has his job done for him now. He can recommend a mutual fund. He doesn't have to do much research. And the buyer doesn't have to make a judgment between one stock and another. He makes it between one fund and another.

Well, this is an unfortunate phenomenon, but it is what is happening. Business is getting bigger and bigger, and buyers and sellers are getting bigger and bigger, and we are losing the individual initiative and imagination that has been ever present in the past. I have noted on two different instances recently people getting into the market as they were in the mid-1920's after reading about the fluctuations. These are the broker-dealers that are watching certain issues very closely and saying to individuals: "You saw what happened to such and such a stock last week." There are still this kind of salesman and this kind of speculator.

There are, once again, a lot of people being sucked into the market—people with small incomes and large families, looking for a quick buck. Now it is the things that move this market that I am concerned about and about which I have raised questions here of other witnesses, specifically whether or not we should either have a separate resolution or, perhaps, as a title to this bill, giving some further authority to the SEC or to the Congress or to the private sector, or a combination of all three, to further explore these trends about which you have just spoken so knowledgeably.

If you have any further comment as to that, in view of my observations, I would appreciate it.

Mr. HAACK. Let me say that I have with me several examples of some of the studies that our research department continues to put out relative to this very subject, so far as volume and activity of institu-

tions, the participation, the effect on markets, and so forth, which I would be happy to leave with you, and I also have a copy of our study of institutional activity for the week of October 24 to 28 last year on this exchange, which I think breaks down some of these things very interestingly and may help you, Mr. Keith, to address yourself and focus on this very problem.

Mr. KEITH. I hope it will. We will do the best that we can.

Mr. HAACK. So far as the wish for a study is concerned, I would say again that we always welcome information. I don't think that we would be in the vanguard of any group to push for it. We would not resist it.

Mr. KEITH. These volume transactions by institutions, there must be a narrowing of the market activity between fewer and fewer firms and fewer and fewer broker-dealers. Some of them must be getting much more successful than others, relatively speaking. When 35 percent of the transactions are involving amounts in excess of 10,000 shares, that means that there is an awful lot of commissions being paid to particular houses that do this business.

Mr. LEVY. It is only 6.7 percent.

Mr. HAACK. I think you misinterpreted my statement. The total institutional activity on the New York Stock Exchange is approximately 32 to 35 percent. In the third quarter of this year there were 1,735 trades, which were not the total institutional orders, which exceeded 10,000 shares.

To answer your question directly, I would say that many firms have focused on the more profitable end of the business. One of the unhappy facts of life is that it costs just as much to process a transaction involving 10 shares as it does 10,000, and some firms are more efficient, some firms are better managed, some firms have better control of costs, and you are absolutely right. Many firms are more successful than their counterparts. This, however, is true of every business.

Mr. KEITH. What does it do to the regional exchanges? Does it encourage them to be more or less active?

Mr. HAACK. I have enough problems speaking for my own members, Mr. Keith, to let alone speak for my friends at regional stock exchanges. The growth of regional stock exchanges has been impressive. They are doing more and more business, just as we are doing more and more business.

There are a number of factors that work to this. They, in some cases, have a different membership. In some cases there is the possible avoidance of a New York transfer tax which we are presently addressing ourselves to in another form.

Mr. KEITH. I believe Massachusetts has a transfer tax, doesn't it?

Mr. HAACK. No.

Mr. CALVIN. It has been repealed.

Mr. KEITH. I am glad I brought the question up.

Mr. HAACK. As a matter of fact the Boston Stock Exchange inserts ads in the Sunday newspapers as to the desirability of doing business in Boston and saving the tax.

Mr. KEITH. What other cost variances are there? Is the commission, generally speaking, about the same?

Mr. HAACK. The commission rate schedules are the same.

Mr. KEITH. Is there some kind of, I won't say collusion, but is there some kind of an understanding that it shall be the same in all regions or is it just by chance?

Mr. HAACK. I would say that it is by chance. We address ourselves to the to the New York commission rate structure, which has been willingly adopted by other exchanges, with no duress or coercion on our part.

Mr. KEITH. We heard Mr. Day, I believe it was yesterday, say that a company that wanted to do business in other States, more or less, had to conform to the laws of New York State, that they had in effect preempted the field. If you want to do business in New York State, you had to have a certain commission on sales.

Mr. LEVY. On insurance.

Mr. KEITH. I understand that. Is there anything comparable here?

Mr. LEVY. No.

Mr. HAACK. It is a free and open marketplace.

Mr. LEVY. Mr. Keith, may I correct one figure? The block transactions comprise about 6.7 percent of the volume in the third quarter, not 35 percent. It was 6.7 percent I believe was the exact figure.

Mr. KEITH. Where did I get the impression that it was 35 percent?

Mr. HAACK. Our total volume from institutions is about 33 percent. The block volume, transactions involving 10,000 shares or more—

Mr. LEVY. In the third quarter.

Mr. KEITH. I see.

Mr. HAACK. Are only 7 percent.

Mr. KEITH. The majority of theirs would be in blocks, but not blocks in excess of 10,000.

Mr. LEVY. Lots of them buy and sell on the dollar averaging basis up and down, and some do it on a daily basis. They buy so many shares a day or sell so many shares a day. Institutions operate all different ways.

Mr. KEITH. Do you mean to say that there are some institutions that by reason of their management philosophy turn a certain portion of the portfolio over?

Mr. LEVY. No, sir.

Mr. KEITH. Periodically?

Mr. LEVY. If they are on a buying program on a given stock they may buy on a scale down or a certain dollar amount every day or sell on the same basis. That is what I meant to imply.

Mr. KEITH. Thank you. On page 6 of your statement, with reference to the contractual plans, you state that possibly a rebate policy should be instituted for certain early terminations involving hardship. Now what do you have in mind there?

Mr. HAACK. Well, I inserted that to eliminate the cancellation which would be frivolous, which would be motivated by, let's say, a market which has declined, for which there is no real sound reason except, say, a weakness on the part of the purchaser.

On the other hand, I can think of some cases where people observing all of the bona fides might through a prolonged illness, the loss of

employment, might be forced to terminate an otherwise sincere program. I think there could well be a differentiation between the two.

Mr. KEITH. The investment companies have seen fit to tie in, to the life insurance business, in order to assure the completion of a plan in the event an investor dies enroute to his final goal, and in order to compete more effectively perhaps with the life insurance industry, would it not be similarly feasible for an investment company to make an arrangement with an insurance company so that if somebody became disabled their monthly payments could be continued?

Mr. HAACK. I am not an insurance expert, but I would think certainly yes. As a matter of fact, we have a variation of that technique which has been embraced by some of our members recently, whereby they provide what is known as debit balance insurance in the case of a customer having a margin account. If the customer should die, the insurance comes into effect and picks up his debit balance, so I would say without complete knowledge that it would be a possibility.

Mr. KEITH. When one considers the arguments that the SEC advances to prohibit the front-end loads, and you counter with positive approaches, it would seem to me that the industry would be on a little sounder ground.

Mr. HAACK. I would agree.

Mr. KEITH. I would be happy to relinquish for the moment but I would like to come back later for a few minutes.

Mr. MOSS. Mr. Stuckey.

Mr. STUCKEY. Thank you, Mr. Chairman.

Mr. Haack, first let me ask you do you consider the mutual fund as a public utility?

Mr. HAACK. Definitely no.

Mr. STUCKEY. Then wouldn't the current bill which is proposed by the SEC, in which they propose to set themselves up as a ratemaking body, in effect make the mutual funds a public utility?

Mr. HAACK. It certainly would.

Mr. STUCKEY. Would you consider the bill before us constitutional or unconstitutional?

Mr. HAACK. I am not an attorney, sir, and I would be reluctant to give an unqualified opinion.

Mr. STUCKEY. Is there anyone that would like to answer that?

Mr. LEVY. None of us. Well, Donald Calvin is an attorney. It is beyond our competence, Mr. Stuckey.

Mr. STUCKEY. I am not surprised. In your exchange with Senator Sparkman and also in your statement you say that the self-regulatory agencies and exchanges within the security business have demonstrated that they can be flexible and responsive to changing conditions. And you have also said that the National Association of Security Dealers would be willing to set themselves up as a governing body. I tend to favor this. I think any time that industry can self-govern themselves that we are this much better off, without Government interference.

Would you like to explain a little bit or expound on that, because we have had a little conflict I think since the time that the letter was written to Senator Sparkman, when the hearings were being con-

ducted on the Senate side. I favor this type of proposal, and I would like to hear really a little bit more than what has been said about it, and do you think that there is a possibility of working this out?

Mr. HAACK. As you know, I have changed hats since I wrote that letter, but I haven't changed my convictions particularly. I think that the supervision or surveillance of sales charges is a natural and complementary function of self-regulation. The industry regulates itself in a number of ways.

It regulates markups on principal transactions. It regulates and supervises underwriting compensation and spreads on new issues of stock. It supervises commissions in the over-the-counter market. It would seem to be almost evolutionary that it would also view this as a reasonable function, the surveillance of sales charges in mutual funds. I think that the industry has acted well and responsibly in this area, and I would see no reason why it couldn't do the same insofar as mutual funds are concerned.

Mr. STUCKEY. I agree with you. Now, your mutual funds are only a small aspect of your new hat now. I mean other individuals come in and out, and we discussed whether an individual trading on his own through a broker is better off than a person investing through mutual funds. Being as you have worn both hats, I would like to read a statement that was made by the Vice President of the United States speaking before the Investment Company Institute in 1965 and see if you would agree with his statement. This is a quotation from the Vice President's talk:

I happen to believe that our great mutual funds represent a source of political stability and economic progress second to none in this nation.

Mr. HAACK. I would agree.

Mr. STUCKEY. So you are saying that the mutuals do have a good effect on the exchange.

Mr. HAACK. Unquestionably.

Mr. STUCKEY. Another area that I would like to get into, and we have discussed the wording if the NASD were to come in and to be self-regulatory, and that has been the use of the words "fair, gross, excessive or unfair." Now the NASD has adopted a rule to govern its members in the matter of mutual fund sales charges using the criteria "unfair."

Can you tell us what procedural steps that the NASD might take to enforce its decision that a sales charge would be unfair, fair, or unreasonable?

Mr. HAACK. Again I can't speak for them, but I would imagine that a study could be made in which transactions would be analyzed by volume, by size, by type of customer, by geographical area, by amount and degree of effort and salesmanship that goes into transactions, large, small, so forth and so on, and that out of this could evolve some kind of a policy.

It might not be unlike the evolution, if you please, of what is known as the NASD markup policy as far as over-the-counter stocks is concerned, in which some 24 years ago a study was made of the over-the-counter market, and out of that came the markup policy which involved

not inflexible standards but the possibility of invoking businessmen's judgment as to what constitutes fair and reasonableness, and I would think that the same approximate technique could be utilized here.

Mr. STUCKEY. Then you think that if some agreement could be reached on the criteria of the wording, that the NASD and the SEC would be this much closer to letting the NASD be a self-governing, self-regulatory body?

Mr. HAACK. Again I can't speak for them, but I would think, on principle, yes.

Mr. STUCKEY. No further questions.

Mr. Moss. On the same matter, with all due deference to my distinguished friend from Georgia, if we were to provide by legislation as we would have to provide, that NASD assume the role of the regulator here, it would be within the limits prescribed by statute, would it not?

Mr. HAACK. You mean with a statutory percentage?

Mr. Moss. No; I don't mean that at all. I mean that the authority would have to be conferred by statute.

Mr. HAACK. Yes.

Mr. Moss. And therefore there would be a regulation by law.

Mr. HAACK. Yes.

Mr. Moss. Through a quasi-public agency, and this would not give to the industry the aspects of a utility.

Mr. HAACK. That is right, sir.

Mr. Moss. And we regulate both at State and Federal law fees paid to attorneys engaged in certain areas of practice. Sometimes the fees are not always regarded as being adequate, but nevertheless we do by law set those fees. This has not taken on the characteristics of a public utility. I merely wanted the record here to reflect the fact that in discussing the proposals of the Securities and Exchange Commission, that it is not necessary that we undertake to change the basic character of the institutions with which we deal.

Mr. HAACK. If I may add one other thing which you appreciate better than I, even with effective self-regulation, there is a substantial degree of oversight emanating from the Commission, and also from this committee, indirectly.

Mr. Moss. That is correct.

Mr. HAACK. Yes.

Mr. Moss. Are there further questions? Mr. Stuckey.

Mr. STUCKEY. There again I want to go back to your statement that you did make, and it goes back to your self-regulatory agencies within your various exchanges. Where this has been set up they have proven to be quite workable and, quoting from you, "to be quite flexible and responsive to changing conditions", and I think the SEC, in all fairness, would say too that this has proven to be an effective means of regulation.

Mr. HAACK. They have, sir.

Mr. STUCKEY. This is why I would like to see and would favor really some type of self-regulation by your dealers, because it has worked well here. It is proven. I think if there were some way where they could get together, it is not that I am saying we don't want the

burden put on our backs. I just think this is a more effective means of doing it, and I certainly would encourage it.

Mr. MOSS. Well, I would not want the record to show that I have intended to imply that the self-regulation presently being exercised has been a failure. That is not my position.

Mr. HAACK. I understand.

Mr. MOSS. Mr. Keith?

Mr. KEITH. Thank you, Mr. Chairman.

In the Senate hearings there is some reference to the Monthly Investment Plan.

Mr. LEVY. Yes, sir.

Mr. KEITH. And I believe it was representatives of the Association of Mutual Fund Plan Sponsors that pointed out that the cost to the individual investor getting in and out of the market in a monthly investment plan is somewhere between 13 and 14½ percent. Is this roughly true?

Mr. HAACK. I don't know the basis on which they come to that conclusion.

Mr. KEITH. Well, it is very well spelled out here on page 397, but let's assume that someone is investing \$60 a month, and they are buying less than 100 shares. On the way in, it costs something in the vicinity of 7.35 percent and on the way out somewhere in the vicinity of 6.53 percent in the case of \$50 stock.

Mr. HAACK. My impression, my recollection is that the maximum, and this is subject to possible correction, but my impression is that the minimum amount that can be invested is \$40 per quarter, and that if the minimum purchase were made, again my recollection is that the commission rate applicable would be 6 percent.

Now, it so happens that many, many plans are started with, say, \$500 or \$1,000, and the subsequent purchases may be \$40 or \$50. When the plan is liquidated, of course, the larger dollar amount would obtain, and the percentage would go down. I don't think it is quite fair to analogize front-end loads with the MIP plan as sponsored by the stock exchange.

First of all, the plan of the front-end load, it embodies or envisions a commitment to fulfill or to go to completion. Under the MIP plan, there is no such understanding, obligation, or commitment, and it can be terminated at any time.

I do have a figure here that the average MIP account payment is some \$85, that the average commission is \$4.81, which is 6 percent. The average plan is in operation about 2 to 2½ years. The average value of a plan at liquidation is something between \$12 and \$1,500, and that the average commission between \$12 and \$1,500 is 1.3 percent. So I would say that the cost in and out is substantially less.

Mr. KEITH. The average commission is 1 percent?

Mr. HAACK. It is 1.3 going out.

Mr. KEITH. Going out. I think that is a valuable contribution, and I would invite your attention to the Senate hearings on page 397, and suggest that you might review the claims that are made there and respond to them more specifically, once again believing that full dis-

closure is the primary purpose in all of these hearings. I would like it to be directed to the committee.

Mr. HAACK. We will do that by letter.

Mr. MOSS. We will hold the record at this point to receive it.
(The following letter was received by the committee:)

NEW YORK STOCK EXCHANGE,
New York, N.Y., November 2, 1967.

Hon. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate
and Foreign Commerce, U.S. House of Representatives, Rayburn House
Office Building, Washington, D.C.

DEAR CONGRESSMAN MOSS: During my recent appearance before the Subcommittee on Commerce and Finance, Congressman Keith requested that I review the data relating to sales charges for Monthly Investment Plan accounts that appears on Page 397 of the Senate Hearings on S. 1659 and that I comment on this data by letter for inclusion in the Record. I am pleased to offer the Exchange's comments in the following paragraphs.

In brief, it is our opinion that while the example appears to be arithmetically correct, given the underlying assumptions, it does not reflect the experience of investors with M.I.P. accounts in a meaningful way. This stems, in large part, from the fact that the example is based on a purchase of less than \$100 and a subsequent sale of less than \$100. Actually, the number of cases where an individual would open an M.I.P. account and later terminate it with total purchases of less than \$100 would be very rare. Further, it is customary to regard the odd-lot differential as part of the price of the security rather than as part of the commission charge.

The experience of our member firms has been that (1) the majority of M.I.P. accounts are started with an initial investment that is substantially greater than the subsequent monthly payments; (2) the typical plan lasts for 2 to 2½ years with a total of 15 to 18 payments; and, (3) when a plan is terminated with a sale, the value of the stock sold is \$1200-1500. The commission charges can be illustrated by the following example, using round figures for purposes of clarity.

	Cost	Commission	
		Amount	Percent
Purchases:			
Initial payment.....	\$500		
10 monthly payments of \$100.....	1,000	\$10	2.0
Total.....		60	6.0
Sale:			
Total amount realized.....	1,500	70	4.7
Commission.....	1,500		
	(1)		

1 \$20 or 1.3 percent.

In this example, commissions amount to six percent of the combined purchases and sales. Other combinations of initial and monthly payments or inclusion of the odd-lot differential could increase commission charges somewhat. It is extremely unlikely, however, in our opinion, that any realistic combination of purchases and sales would result in a total commission charge approaching 13 percent. This would be so even if the maximum charge shown on Page 397 of the Senate hearings is assumed to apply to the initial purchase. The accumulation of monthly payments together with appreciation during the period of the plan could be expected to result in a substantially lower commission charge on the terminal sale. As shown in the example, while commissions represented 4.7 percent of total purchases, the Commission on the sale amounted to only 1.3 percent of the sum realized.

I might also point out that termination of an M.I.P. account does not necessarily mean that the investor sells his accumulated shares. About two-thirds of the investors who terminate their M.I.P. accounts simply notify their brokers that they are discontinuing their monthly or quarterly payments and ask for delivery of the certificate. This is presumably added to the investor's long term holdings.

Let me again express my appreciation to yourself and to the Committee for your courtesy and interest during my appearance.

Cordially,

ROBERT W. HAACK,
President.

Mr. KEITH. I realize that it is not your bailiwick, necessarily, and you are not an attorney, but perhaps Mr. Calvin could comment. Do you feel that the mutual funds function as a fiduciary, in essence?

Mr. CALVIN. The problem I have in answering that is that a fiduciary, the term "fiduciary," is a broad and often widely used term.

Mr. KEITH. Well, in the generally accepted sense of the law in the State of Massachusetts.

Mr. CALVIN. Well, I am not admitted to practice law in Massachusetts.

Mr. KEITH. Where did you go to law school?

Mr. CALVIN. University of Illinois.

Mr. KEITH. All right, in the State of Illinois.

Mr. CALVIN. In the State of Illinois—

Mr. KEITH. I understand that most States turn to Massachusetts for its law as pertains to trusts.

Mr. CALVIN. Well, in the case of a Massachusetts trust, I would say that my recollection, my law school recollection of law, is that under the Massachusetts trust I think the relationship is that of beneficiary fiduciary, but I wouldn't pose as an expert in that area.

Mr. KEITH. Would that account, perhaps, for an internally managed fund having a smaller advisory fee?

Mr. CALVIN. Again I would qualify the answer I am about to give is that I am really not an expert in this area, but it has been my understanding that that would not be the reason. But again I certainly am not an expert in trust law in Massachusetts.

Mr. KEITH. It has just been pointed out to me that we have, later on today, Mr. Milton H. Cohen, as a witness. He is representing Scudder, Stevens & Clark. I will ask him that question.

Mr. CALVIN. I would much appreciate that.

Mr. KEITH. I will reserve the other questions I had in mind for Mr. Haack.

Mr. MURPHY. Some States, Mr. Chairman, turn to Massachusetts for even more than this advice, Mr. Keith.

Mr. KEITH. I realize that. We have had a lot of presidents from Massachusetts.

Mr. HAACK. Mr. Chairman, may I request that we be able to leave the folder that you have with you and that I might also leave a couple of other memorandums with you?

Mr. MOSS. Yes.

Mr. HAACK. For your information and not particularly for the record.

Mr. Moss. We would be very pleased to receive them for the files of the committee at this point. They may be included in the record after the committee has had an opportunity to study them.

I want to thank you gentlemen for your appearance. You are now excused.

(The following material was submitted by the New York Stock Exchange:)

NEW YORK STOCK EXCHANGE MEMORANDUM

SEPTEMBER 15, 1967.

To:
From: Stan West.
Subject: Institutional Activity—Second Quarter 1967.

HIGHLIGHTS

Aggregate purchases and sales of common stock by four major types of institutions (noninsured private pension funds, mutual funds, life insurance companies, and property and casualty companies) rose to an all-time high of \$11.4 billion in the second quarter, up 10% from the previous quarter.

Net purchases of common stock by these institutional investors were \$2.2 billion, also a record high. Noninsured private pension funds alone accounted for \$1.3 billion and mutual funds \$0.6 billion.

The turnover rates of noninsured private pension funds (16.4%) and life insurance companies (18.0%) rose to record highs in the second quarter. The mutual fund rate of 39.2% was only slightly lower than the previous quarter.

TURNOVER RATIOS OF COMMON STOCK BY INSTITUTIONS

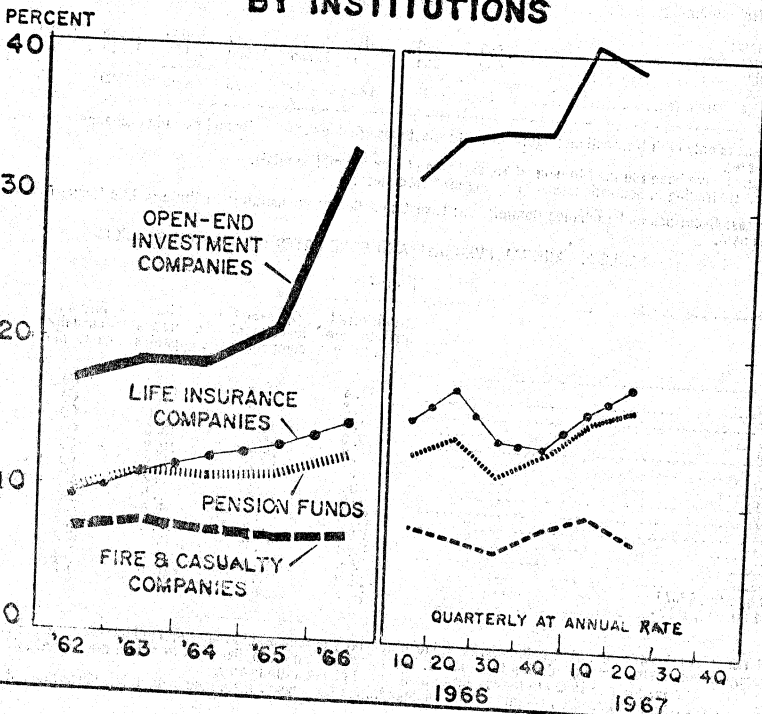


TABLE 1.—PURCHASES, SALES, AND NET ACQUISITIONS OF COMMON STOCK¹ BY CERTAIN FINANCIAL INSTITUTIONS AND FOREIGNERS
[In millions of dollars]²

	Quarterly averages				1966			1967	
	1963	1964	1965	1966	April-June	July-September	October-December	January-March	April-June
Private noninsured pension funds:									
Purchases.....	940	1,095	1,395	1,655	1,825	1,505	1,700	2,120	2,510
Sales.....	390	525	640	750	830	605	680	975	1,170
Net purchases.....	550	570	755	905	995	900	1,020	1,150	1,340
Open-end investment companies:									
Purchases.....	1,000	1,190	1,632	2,585	2,780	2,315	2,525	3,525	3,630
Sales.....	810	970	1,290	2,325	2,420	2,575	2,200	2,730	3,040
Net purchases.....	195	220	340	260	365	-260	325	800	590
Life insurance companies:									
Purchases.....	145	200	240	245	280	210	220	315	410
Sales.....	100	115	145	195	245	180	155	200	225
Net purchases.....	40	85	100	50	40	35	65	120	185
Property and casualty insurance companies:									
Purchases.....	180	190	190	220	230	205	260	275	265
Sales.....	150	165	175	150	130	100	125	210	175
Net purchases.....	30	25	15	70	100	105	135	65	90
Total (items 1-4, inclusive):									
Purchases.....	2,265	2,675	3,460	4,710	5,120	4,235	4,710	6,240	6,815
Sales.....	1,450	1,775	2,250	3,425	3,625	3,460	3,165	4,110	4,610
Net purchases.....	815	900	1,210	1,285	1,495	775	1,545	2,130	2,205
Foreigners: ³									
Purchases.....	680	770	910	1,175	1,445	1,000	1,035	1,550	1,890
Sales.....	630	855	1,035	1,255	1,520	1,025	1,215	1,585	1,755
Net purchases.....	50	-90	-125	-80	-75	-30	-180	-35	135

¹ Includes only cash transactions; figures do not reflect stock dividends or splits and exclude exchanges of one security for another.

² Figures have been rounded to nearest \$5,000,000 and may not add to totals.

³ Reflects trading in domestic issues including preferred stock.

Sources: Securities and Exchange Commission; Investment Company Institute; Institute of Life Insurance; Treasury Department.

TABLE 2.—ANNUAL PURCHASE AND SALE RATES OF COMMON STOCK¹
[In percent]

	Noninsured private pension funds ²	Open-end investment companies	Life insurance companies	Fire and casualty companies ³	NYSE ⁴
1955.....	11.8	15.9	11.8	(9)	17
1956.....	11.8	18.6	11.5	(9)	14
1957.....	11.9	18.8	12.0	(9)	13
1958.....	12.0	21.7	13.0	(9)	14
1959.....	11.7	19.8	10.9	(9)	15
1960.....	11.1	17.6	9.9	(9)	12
1961.....	12.1	20.0	13.2	(9)	15
1962.....	9.7	17.3	9.5	7.1	13
1963.....	11.0	18.6	11.0	7.8	15
1964.....	10.8	18.7	12.2	7.4	13
1965.....	11.3	21.2	13.2	6.9	15
1966.....	12.6	33.5	14.5	7.2	19
1st quarter, 1967 ⁷	15.2	40.8	16.0	9.2	23
2nd quarter, 1967 ⁷	16.4	39.2	18.0	7.6	23

¹ Turnover rates are computed as the market value of quarterly purchases plus sales divided by twice the market value of average common stockholdings during the quarter. The result is then multiplied by 4 to obtain the annual rate.

² Turnover rates prior to 1959 are for corporate noninsured pension funds only.

³ Turnover rates are based on common stockholdings minus holdings of insurance companies, since most of the latter are intercorporate holdings.

⁴ Market value basis, not shares.

⁵ Not available.

⁶ Revised.

⁷ Annual rate.

TABLE 3.—ANNUAL TURNOVER RATES OF COMMON STOCK OF NONINSURED PRIVATE PENSION FUNDS
[In percent]

	Purchase rate	Sale rate	Purchase and sale rate
Noninsured private pension funds:			
1955.....	18.3	5.3	11.8
1956.....	19.1	4.4	11.8
1957.....	20.3	3.6	11.9
1958.....	19.6	4.3	12.0
1959.....	18.7	4.6	11.7
1960.....	17.6	4.5	11.1
1961.....	18.1	6.2	12.1
1962.....	14.8	4.6	9.7
1963.....	15.6	6.5	11.0
1964.....	14.6	7.0	10.8
1965.....	15.6	7.1	11.3
1966.....	17.3	17.8	12.6
1st quarter, 1967 (annual rate).....	20.8	9.6	15.2
2d quarter, 1967 (annual rate).....	22.4	10.4	16.4

¹ Revised.

Note.—Turnover rates prior to 1959 are for corporate noninsured pension funds only.

TABLE 4.—ANNUAL TURNOVER RATES OF COMMON STOCK OF OPEN-END INVESTMENT COMPANIES
[In percent]

	Purchase rate	Sale rate	Purchase and sale rate
Open-end investment companies:			
1955.....	19.1	12.7	15.9
1956.....	22.4	14.8	18.6
1957.....	23.7	13.9	18.8
1958.....	27.2	16.2	21.7
1959.....	23.9	15.8	19.8
1960.....	20.4	14.7	17.6
1961.....	23.6	16.4	20.0
1962.....	19.9	14.7	17.3
1963.....	20.6	16.6	18.6
1964.....	20.6	16.8	18.7
1965.....	23.7	18.7	21.2
1966.....	35.2	31.7	33.5
1st quarter, 1967 (annual rate).....	45.6	35.6	40.8
2d quarter, 1967 (annual rate).....	42.8	36.0	39.2

TABLE 5.—ANNUAL TURNOVER RATES OF COMMON STOCK OF LIFE INSURANCE COMPANIES
[In percent]

	Purchase rate	Sale rate	Purchase and sale rate
Life insurance companies:			
1955.....	13.4	10.2	11.8
1956.....	11.7	11.2	11.5
1957.....	13.4	10.7	12.0
1958.....	14.4	11.5	13.6
1959.....	13.1	8.7	10.9
1960.....	12.5	7.2	9.9
1961.....	16.3	10.0	13.2
1962.....	13.3	5.8	9.5
1963.....	12.9	9.1	11.0
1964.....	15.4	8.9	12.2
1965.....	16.6	9.8	13.2
1966.....	16.2	12.8	14.5
1st quarter, 1967 (annual rate).....	19.6	12.4	16.0
2d quarter, 1967 (annual rate).....	23.6	12.8	18.0

¹ Revised.

TABLE 6.—ANNUAL TURNOVER RATES OF COMMON STOCK OF FIRE AND CASUALTY INSURANCE COMPANIES
[In percent]

	Purchase rate	Sale rate	Purchase and sale rate
Fire and casualty insurance companies:			
1962.....	8.3	5.8	7.1
1963.....	8.5	7.2	7.8
1964.....	7.9	6.8	7.4
1965.....	7.2	6.6	6.9
1966.....	8.6	5.8	7.2
1966.....	10.4	8.0	9.2
1st quarter, 1967 (annual rate).....	9.2	6.0	7.6
2d quarter, 1967 (annual rate).....			

¹ Revised.

Note.—Turnover rates are based on common stockholdings minus holdings of insurance company issues since most of the latter involve intercorporate holdings.

INSTITUTIONAL HOLDINGS OF NYSE-LISTED STOCK—1966

Institutional Holdings

The attached table gives the latest estimates on institutional holdings of NYSE-listed stocks for 1949 and 1956-66.

At the end of 1966, preliminary estimates show institutions holding \$101.1 billion of NYSE-listed stock. This was 21.0% of the total list outstanding, up from a revised figure of 20.7% in 1965, 15.8% in 1956 and 12.7% in 1949.

The reason for the proportionate increase in institutional holding in 1966 is that, despite the 1966 market decline, institutions continued to purchase stock on balance, while individuals were selling. For example, in the first three quarters of 1966, net purchases of all common stock (listed and unlisted) were \$2.6 billion by non-insured pension funds, \$0.7 billion by mutual funds, and \$0.3 billion by insurance companies.

Non-insured pension funds, the largest group of institutional stockholders, owned almost \$35 billion, or 7.2%, of NYSE-listed stock at the end of 1966. Investment companies, the second largest, held \$28 billion, or 5.8% of listed stock.

Personal Trust Funds

At the end of 1966, bank-administered personal trust funds (excluding common trust funds) held an estimated \$56 billion of NYSE-listed stock. This compares with \$65 billion in 1965 and \$58 billion in 1964, with most of the changes due to price appreciation and depreciation.

These estimated personal trust holdings are equal to about 12% of all NYSE-listed stocks outstanding. Thus, at year-end 1966, institutions and personal trust funds combined held an estimated \$157 billion of listed stock, or about one-third of the Exchange's total list.

ESTIMATED HOLDINGS OF NYSE-LISTED STOCKS BY FINANCIAL INSTITUTIONS
 [Dollar amounts in billions]

Type of institution	Yearend											
	1949	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966 ¹
Insurance companies:												
Life.....	\$1.1	\$2.3	\$2.2	\$2.7	\$2.9	\$3.2	\$4.0	\$4.1	\$4.6	\$5.3	\$6.4	\$6.0
Nonlife.....	1.7	4.5	4.1	5.4	5.7	6.0	7.7	7.1	8.2	9.5	10.1	8.9
Investment companies:												
Open end.....	1.4	7.1	6.5	10.2	11.6	12.4	17.2	15.4	18.6	21.8	26.5	24.1
Closed end.....	1.6	4.0	3.5	4.4	5.2	4.2	5.6	5.3	5.7	6.6	5.6	4.0
Noninsured pension funds:												
Corporate.....	.5	5.3	5.6	9.4	11.8	13.5	18.7	17.9	22.6	27.5	32.5	30.8
Other private.....	(2)	.4	.3	.6	.7	.8	1.1	1.0	1.3	1.6	1.9	1.9
State and local government.....	(2)	.2	.2	.3	.4	.5	.7	.8	1.1	1.5	1.9	1.9
Nonprofit institutions:												
College and university endowments.....	1.1	2.4	2.1	2.8	3.0	2.9	3.7	3.3	4.0	4.5	5.1	4.4
Foundations.....	1.1	4.1	3.4	5.0	5.4	5.3	7.2	6.7	8.3	9.5	10.1	8.8
Other.....	1.0	3.1	2.8	4.0	4.4	4.4	5.6	5.0	5.9	6.8	7.7	6.9
Common trust funds.....	(2)	1.0	1.0	1.3	1.4	1.4	1.9	1.7	2.2	2.6	3.2	2.9
Mutual savings banks.....	.2	.2	.2	.3	.3	.2	.3	.4	.4	.4	.5	.5
Total.....	9.7	34.6	31.9	46.4	52.8	54.8	73.7	68.7	82.9	97.6	111.5	101.1
Market value of all NYSE-listed stock.....	76.3	219.2	195.6	276.7	307.7	307.0	387.8	345.8	411.3	474.3	537.5	482.5
Estimated percent held by all institutions.....	12.7	15.8	16.3	16.8	17.2	17.9	19.0	19.9	20.2	20.6	20.7	21.0

¹ Preliminary estimates.

² Less than \$50,000,000.

NEW YORK STOCK EXCHANGE MEMORANDUM

To:

OCTOBER 9, 1967.

From: Stan West

Subject: NYSE Large Block Transactions (10,000 Shares or more)—3rd Quarter 1967

Block activity in the third quarter reached new highs in all respects—number of blocks, shares, and percent of reported volume:

1. *Number*—The 1,725 blocks in the third quarter were 5% above the second quarter total and almost double the 900 blocks in the third quarter 1966.

2. *Shares*—The 42 million shares traded compared with 40 million in the second quarter and 20 million in the third quarter 1966.

3. *Percent of Reported Volume*—Block volume rose to a record 6.7% of NYSE reported volume, the seventh consecutive quarter in which this proportion increased.

LARGE BLOCK TRANSACTIONS ON NYSE

MIL. SHARES

50

■ SHARES
SCALE

□ PERCENT OF NYSE
REPORTED VOLUME
SCALE

40

30

20

10

0

PERCENT

-15

-10

-5

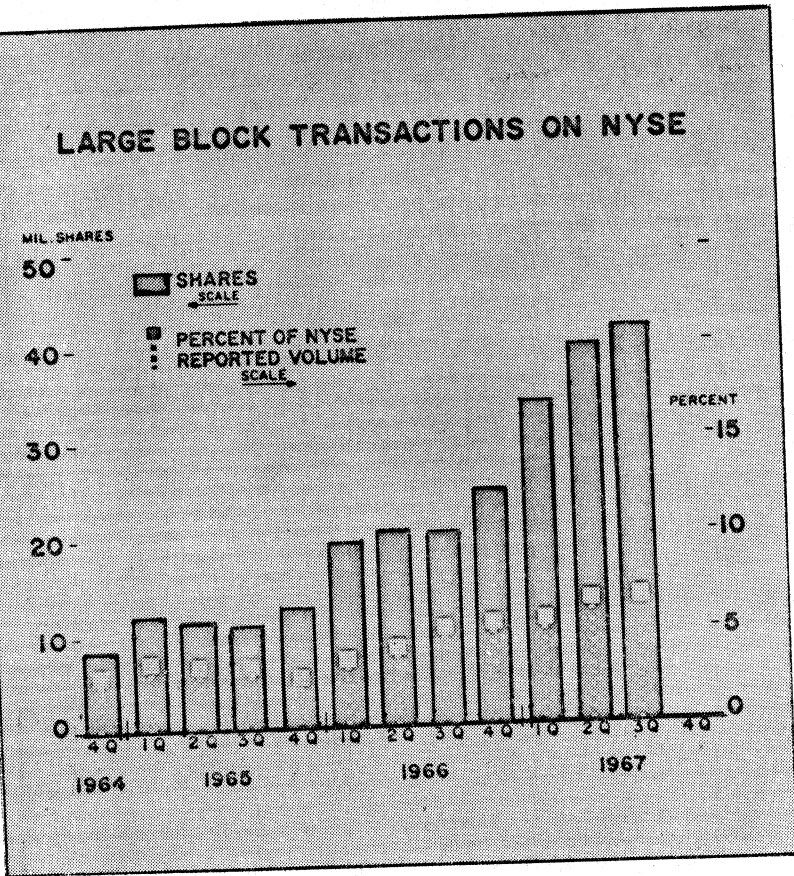
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1964

1965

1966

1967



NYSE BLOCK TRANSACTIONS
TABLE 1.—4TH QUARTER 1964—3D QUARTER 1967

	Number of transactions	Block volume		Market value (in millions)	Number of issues
		Shares	Percent of reported volume		
1964: 4th quarter.....	399	8,812,000	2.9	\$297.8	250
1965:					
1st quarter.....	538	12,405,000	3.6	469.7	295
2d quarter.....	505	11,706,000	3.3	480.0	279
3d quarter.....	529	11,252,000	3.2	428.8	287
4th quarter.....	599	12,899,000	2.6	478.9	301
1965 total.....	2,171	48,262,000	3.1	1,857.4	
1966:					
1st quarter.....	841	19,685,000	3.6	723.1	384
2d quarter.....	922	20,566,000	4.1	828.9	415
3d quarter.....	900	20,364,000	5.1	830.0	407
4th quarter.....	979	24,683,000	5.4	921.2	434
1966 total.....	3,642	85,298,000	4.5	3,303.2	
1967:					
1st quarter.....	1,385	33,917,000	5.5	1,326.5	508
2d quarter.....	1,650	39,694,000	6.4	1,588.0	570
3d quarter.....	1,725	41,970,767	6.7	1,658.9	582
Average per transaction					
		Shares	Value	Average price	
1964: 4th quarter.....	22,085		\$746,000	33 $\frac{3}{4}$	
1965:					
1st quarter.....	23,058		873,000	37 $\frac{7}{8}$	
2d quarter.....	23,180		950,000	41 $\frac{1}{2}$	
3d quarter.....	21,170		811,000	38 $\frac{1}{8}$	
4th quarter.....	21,534		799,000	37 $\frac{1}{8}$	
1965 total.....	22,230		856,000	38 $\frac{1}{2}$	
1966:					
1st quarter.....	23,407		860,000	36 $\frac{3}{4}$	
2d quarter.....	22,306		899,000	40 $\frac{3}{8}$	
3d quarter.....	22,627		922,000	40 $\frac{3}{4}$	
4th quarter.....	25,212		941,000	37 $\frac{3}{8}$	
1966 total.....	23,421		907,000	38 $\frac{3}{4}$	
1967:					
1st quarter.....	24,489		958,000	39 $\frac{1}{8}$	
2d quarter.....	24,057		962,000	40	
3d quarter.....	24,331		961,700	39 $\frac{1}{2}$	

TABLE 2.—METHODS OF EXECUTING NYSE TRANSACTIONS OF 10,000 SHARES OR MORE DURING 3D QUARTER 1967

Type of procedure	Transactions		NYSE share volume		Market value	
	Number	Percent	Shares (thousands)	Percent	Amount (millions)	Percent
Regular executions.....	983	57	19,369	46	\$719.9	44
Crossing of orders ¹	729	42	22,108	53	916.3	55
Exchange distributions.....	13	1	494	1	22.7	1
Total.....	1,725	100	41,971	100	1,658.9	100

¹ For purposes of this study, a "cross" is defined as an execution where 1 member firm is involved at least partially on both the purchase and sale side of the transaction.

TABLE 3.—AVERAGE SIZE OF TRANSACTIONS OF 10,000 SHARES OR MORE IN 3D QUARTER 1967 BY METHOD OF EXECUTION

Type of procedure	Average number of shares per trade	Average value per trade	Average price per share
Regular executions.....	19,704	\$732,375	37 $\frac{1}{8}$
Crossing of orders.....	30,326	1,256,930	41 $\frac{1}{2}$
Exchange distributions.....	38,023	1,747,878	46
Total.....	24,331	961,710	39 $\frac{1}{2}$

TABLE 4.—SIZE OF NYSE TRANSACTIONS OF 10,000 SHARES OR MORE EXECUTED DURING 3D QUARTER 1967

Number of Shares	Transactions		Market value	Transactions	
	Number	Percent		Number	Percent
10,000 to 10,999.....	488	28	Less than \$100,000.....	60	3
11,000 to 14,999.....	363	21	\$100,000 to \$499,999.....	615	36
15,000 to 24,999.....	444	26	\$500,000 to \$999,999.....	572	33
25,000 to 49,999.....	285	17	\$1,000,000 to \$4,999,999.....	447	26
50,000 and over.....	145	8	\$5,000,000 and over.....	31	2
Total.....	1,725	100	Total.....	1,725	100

(The following correspondence with the American Stock Exchange was submitted for the record by the committee. The letter referred to below, addressed to Mr. Keith Funston, New York Stock Exchange, may be found on p. 534.)

HOUSE OF REPRESENTATIVES,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., August 3, 1967.

Mr. RALPH SAUL,
President, American Stock Exchange,
New York, N.Y.

DEAR MR. SAUL: Today I have written Mr. Keith Funston, President of the New York Stock Exchange, requesting his comments on the current activity in the stock markets, a copy of which I am enclosing you. It is my thought that you may also wish to address yourself to the same subject as it applies to your exchange.

Sincerely yours,

HARLEY O. STAGGERS,
Chairman.

AMERICAN STOCK EXCHANGE,
New York, N.Y., August 22, 1967.

HON. HARLEY O. STAGGERS,
Chairman,
Interstate and Foreign Commerce Committee,
Congress of the United States,
House of Representatives,
Washington, D.C.

DEAR CHAIRMAN STAGGERS: I appreciate the opportunity afforded to us by your letter of August 3, 1967 to discuss the measures taken and planned by the American Stock Exchange in light of current activity in the stock market.

As you noted in your letter to Mr. Funston, the level of the activity on the exchanges has increased dramatically during the last year and current volume is at record levels. The American Stock Exchange has implemented a number of programs to assure the efficient operation of the auction market and as volume has continued to grow, we have taken a number of other steps so that we may continue to provide a fair and orderly marketplace responsive to public needs.

To keep you and your Committee informed on developments at the Exchange, I should like to enumerate the measures we have taken and those we plan to take involving Exchange facilities and operations:

Floor Procedures—During the Hearings before the Subcommittee on Commerce and Finance in early 1964, you expressed an interest in the procedures of the Exchange for halting trading in emergency situations. Your interest in this matter arose as a result of market conditions following the assassination of President Kennedy. The Exchange subsequently adopted new procedures to permit prompt action to meet fast changing market situations and we believe these procedures have worked well.

These procedures were adopted to deal with emergency situations but we have found that they can be applied in unusual market situations involving timely disclosure by listed companies of material corporate developments. Under the Exchange's listing agreement, a listed company is required to "make prompt public disclosure of any material developments in its affairs and operations, whether favorable or unfavorable, which might significantly affect the market for its securities or influence investment decisions." The Exchange is usually alerted to timely disclosure problems when its Surveillance Division detects unusual activity in a stock. A call to the company may reveal that significant corporate information has not been released to the public. The policy of the Exchange is to halt trading whenever there are indications that news of significant corporate developments is available to some buyers and sellers but not to others.

Under our special floor procedures, floor officials have the authority to halt trading in an issue. Floor officials will continue a halt in trading until the company has made public disclosure of the development and there has been a sufficient period after dissemination to allow the public to evaluate and act on the news.

The Exchange's ability to act promptly upon unusual market situations reflects improved liaison between floor officials on the floor and the Exchange administration.

Market Data Systems.—Last year a floor input system designed to speed the reporting of market information went into full operation. This system has virtually eliminated the manual processing of sales and quotation slips before data is printed on the ticker, reducing the lapsed time between a transaction and its report on the tape from three minutes to less than 30 seconds.

The Exchange's plans for conversion to a 900 character-per-minute (cpm) ticker are reaching fruition. As of September 5, 1967, market information at the higher 900 cpm speed will be transmitted to desk unit devices and to the press. Conversion of the ticker installations is now underway and we expect that the entire ticket network should be converted by early 1968. The Exchange has an obligation to the public to insure the dissemination of up-to-date market information and, consequently, we have made conversion of our market data systems a matter of highest priority.

Automation of Clearing.—An automated compared clearance program, in which reports of buyers and sellers are matched, is scheduled to go on line later this fall. This automated system should prove helpful to member firm operations, relieving back offices of some of the paper processing problems which recently required shorter trading hours.

Market Surveillance.—In December 1965, the Exchange amended its rules so that it could prescribe higher initial margin requirements in issues where speculative activity appeared to exist. Recent Exchange studies indicate that the selective margin program has been a valuable tool in controlling speculative activity. Since May 1, 1967, the Exchange has imposed selective margin controls on 38 issues.

In situations where unusual activity is noted, the Exchange is promptly contacting managing partners and officers of member organizations involved. While previously back office employees were contacted as part of our routine surveillance procedures, this new procedure is intended to emphasize the importance the Exchange attaches to such a referral. We have been using this technique on a selective basis where we believe it is necessary to emphasize our concern.

To aid in this program, the Exchange is obtaining every half hour a print out of the 35 most active stocks including last sale and net change. Where the situation appears to warrant it, an immediate follow up is instituted. Specialists have also been urged to report promptly unusual market situations which will provide timely follow up by our Surveillance Division. The Exchange is now making available to each clearing member organization a summary weekly and monthly report of purchases and sales in all securities traded on the Exchange by security and its percentage of Exchange volume in each security. This has

proved to be a helpful tool not only to the Exchange, but also to members in supervising the activities of their employees.

Early this year, the Exchange began surveying a nationwide sampling of member organization branch offices on a periodic basis to assess the extent and quality of public participation in American Stock Exchange issues. These surveys provide the Exchange with an indication of the nature of high volume markets and help to identify the point at which the Exchange should consider taking cautionary or other action.

During recent weeks, speculative trading activity has been a source of increased concern to member organizations and to the Exchange. On July 11, 1967, the Exchange recommended to its members that they give special attention to firm sales policies and procedures to determine their adequacy and effectiveness in light of current market conditions and investor attitudes. The Exchange emphasized that members should step up their efforts to see that the implications of current activity are carefully weighed by all investors.

Listing Standards.—Strengthening of Exchange listing standards over the past five years is now bearing fruit in the listing of securities of quality companies. However, the Exchange must continue to assure itself that a security is suitable for auction market trading and that the issuer of the security is in a position to meet the obligations assumed by listing. We have previously indicated to the Committee that we are testing the adequacy of present listing and delisting criteria in light of past experience and changing market conditions. In this connection, last month we revised our listing requirements to obtain more detailed data on the distribution of shares of issuers applying for listing. The new requirements will aid in evaluating an issue's suitability for auction market trading by enabling the Exchange to determine whether an issue has only local interest and the extent to which the public float includes substantial blocks owned by institutions and insiders.

Future Programs.—At our Annual Meeting in May, a major facilities program involving the trading floor and related member and public facilities was announced. By modernizing our trading floor, we will be able to provide a public auction market, not only under today's high volume conditions, but with even greater volume expected in the future.

We cannot precisely foresee, at this time, the eventual scope of the assistance that may be offered by automation. We are presently surveying our overall automation planning and we hope eventually to have an on-line stock watch system, a transaction journal and other means of rapidly ascertaining when unusual activity occurs and the source of such activity.

I hope this letter is helpful in bringing you up to date on developments of the Exchange. If it appears that we can provide further information of possible use to you and your Committee members, I hope you will be in touch with us.

Sincerely,

RALPH S. SAUL, *President.*

Mr. Moss. Our next witness is Mr. James E. Day, president of the Midwest Stock Exchange.

We must have order, in order that the time of the committee can be conserved. Mr. Day, you may proceed.

STATEMENT OF JAMES E. DAY, PRESIDENT, MIDWEST STOCK EXCHANGE; ACCOMPANIED BY FRANK J. ROTHING, SENIOR VICE PRESIDENT; JOHN G. WEITHERS, VICE PRESIDENT AND SECRETARY; AND JOSEPH N. MORENCY, JR., LEGAL COUNSEL

Mr. DAY. Mr. Chairman, in an effort to conserve time, may I request your permission to enter our formal statement in the record?

Mr. Moss. Without objection, the permission is granted.

Mr. DAY. I will merely give excerpts of the major points, and hopefully a clearer and somewhat expanded presentation in our summary.

Mr. Moss. Thank you. You may proceed.

Mr. DAY. Mr. Chairman, I am James E. Day, president of Midwest Stock Exchange, located in Chicago, Ill. With me today from our

exchange are Frank J. Rothing, senior vice president, John G. Weithers, vice president and secretary, and Joseph N. Morency, Jr., legal counsel. We appreciate this opportunity to be heard on H.R. 9511 and 9510.

Although this bill would make changes only in the Investment Company Act and the Investment Advisers Act, thereby altering the regulatory structure applicable to investment companies, investment advisers and underwriters, our Exchange members realize they have an important stake in the end result. We are here in the interest of our members.

Generally speaking, it is our view that, since the Securities and Exchange Commission has not provided sufficient facts and supporting evidence, in our judgment, to justify these concrete proposals, we must go on record in general opposition to H.R. 9511 and H.R. 9510.

It is our conviction that the problems involved are extremely complex and need analysis in depth before proper legislation can be proposed. We believe that the bill was portrayed too simply by the Securities and Exchange Commission's Chairman when he said in effect:

It is the purpose of the bill to give a fair shake to the more than four million Americans now owning mutual fund shares, and this can be done by reducing the sales load imposed on the acquisition of fund shares and by providing a way in which unreasonably high management fees can be reduced. This is the sum and substance of the bill.

Evaluation of this proposed legislation is complicated by the fact that it is based on an extensive document, prepared by the Securities and Exchange Commission and submitted to the Congress. This Securities and Exchange Commission report recommends substantial changes in stock exchange commission rate structure, reciprocity and other areas vitally important to the operations of the securities industry which are far beyond the scope of this bill. We realize and respect the fact that this bill is mainly confined to lowering sales loads and management fees and prohibiting front-end loads. Nevertheless, we submit all of the Securities and Exchange Commission recommendations are interrelated.

The Securities and Exchange Commission has pointed out the spectacular growth of mutual funds in recent years and the problems involved in the institutionalization of the marketplace. They further suggest the growing concentration of economic power over prices of individual stocks and corporations in the hands of a relatively small group of fund managers poses problems for investors, the investment industry and the orderly functioning of our capital-raising mechanisms. Obviously, these problems will not be solved by a simple reduction in profits, sales loads, or advisers' fees. These complex areas give us genuine concern. We do not have answers for them. That is why we feel strongly that further economic analysis and study is urgently needed if changes are to be made.

This bill, giving the Securities and Exchange Commission rate-making powers, is patently impractical and unreasonable. The various elements in the securities industry are in active and constant competition with each other for business. Securities firms are regulated, but they have no exclusive franchise as public utilities do. They also compete with insurance companies, banks, and other financial institutions for the savings dollars of the American people. Nonetheless, the

plain thrust of the Securities and Exchange Commission's proposal to Congress is to reduce profits by giving them authority to reduce charges.

Recent developments in the securities markets have convinced us that this proposed legislation cannot be evaluated properly until these major questions have been carefully considered:

1. What are the capital needs of our economy over the next 20 years?
2. Where will this money come from?
3. To what extent would these Securities and Exchange Commission proposals be harmful to the capital-raising structure of our country? We don't know.
4. Do the present methods and techniques of buying and selling by mutual funds cause erratic price swings in issues in which they have a substantial interest, or will they in the future?
5. Will the continuation of large block buying by all institutions change the whole concept of future financing and marketing of securities?
6. Will the funds, if they sustain their present rate of growth, dry up liquidity in the various marketplaces?

The Securities and Exchange Commission raises the institution's impact on liquidity in their mutual fund study¹ and I quote:

The growing importance of institutional investors in the stock markets has a significant impact on the securities markets. To the extent that irregular and relatively infrequent transactions in sizable blocks of securities by large institutional investors become more significant and orders from small investors become less significant, the markets for individual securities become more susceptible to wide and erratic price fluctuations.

Strangely, this Commission-sponsored legislative proposal makes no attempt to deal with the recognized problems resulting from increased institutionalization.

Liquidity in an auction market is provided by a continuous daily flow of 100 to 500-share orders in sufficient quantities to satisfy all normal pressures of supply and demand without leading to erratic price fluctuations. We would have to oppose, therefore, any pricing structure that would contain a volume discount that would make it attractive, in and of itself, for investors to bunch their orders through some institutional vehicle. This would have two undesirable effects:

1. Many smaller- and medium-size orders would be removed from the marketplace, thus reducing existing liquidity.
2. By routing orders through an institutional vehicle, they would become larger and exert extraordinary pressures on the market as clearly delineated by Chairman Cohen.

Most importantly, any spectrum of pricing that provides a discount for larger orders, by its very definition, either directly or indirectly, places a more than proportionate burden of cost on the small individual investor.

H.R. 9511 is a result of studies by the Securities and Exchange Commission, its staff and consultants, conducted pursuant to section 14(b) of the Investment Company Act of 1940. In that subsection, Congress authorizes the Commission to make a study and investigation when and if it finds—

¹ House Rept. Number 2337 on public policy implications of investment company growth, p. 26.

... any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest

The very language used shows Congress was interested in the size of mutual funds and the resultant impact that increased size might have on investors or the public interest. These legislative proposals in H.R. 9511 fail to meet problems resulting from the increased size of mutual funds and thus miss the target Congress invited the Securities and Exchange Commission to focus upon when section 14(b) was added to the Investment Company Act.

CONCLUSION

H.R. 9510 and 9511 has been urged upon you as a legislative solution to limited problem areas which actually have yet to be studied in depth. We have spelled out six major problem areas which we feel richly deserve thorough investigation and careful evaluation, but the bill deals with none of them.

We are not opposed to the action in these areas but we are opposed to any legislative action before it is clearly understood what the results will be. We do not know if the proposed reduction in charges for mutual funds would increase or lessen the sale of this form of investment. The Securities and Exchange Commission has presented previous testimony virtually admitting that they do not know either.

The so-called institutionalization of the market is obviously the main thrust of the Securities and Exchange Commission. This is our concern, too, and as we have testified, the resultant impact on market liquidity.

Chairman Cohen testified on the second day of your committee hearings, in answer to a question I believe by you, Mr. Chairman, that—

Certainly we feel that the problem is growing and additional steps be required. We are worried that some of these activities will produce a disorderly market, even if only in particular times.

We assume from this that he is generally concerned about the liquidity in the marketplace, and we repeat we certainly are. We do not appear before you to say there are no problems in these areas treated by this bill, because we know they are there. We are trying to get across the blunt truth that what appears to be a relatively simple piece of legislation in the interests of the public will not necessarily bring those results. We are not surprised by the existence of the problems, but we are dismayed by the lack of overall planning relative to the definition and solution of the truly major problems that face the future of the public and our marketplaces.

Therefore, Mr. Chairman, we recommend that Congress establish a joint industry-Commission study to consider these major problem areas in depth and then recommend to Congress a legislative program which is responsive to the conclusions resulting from such an appraisal. We believe such a study could be completed in a relatively short period of time, without the necessity of substantial appropriation.

Further, to prevent any possible bias of either our industry or the Securities and Exchange Commission from slowing down such a study, or from limiting the potential, we would suggest that representatives of the Federal Reserve Board could be included along with members

from your committee, Mr. Chairman, and members of the Senate committee.

Thank you very much.

Mr. MOSS. Thank you, Mr. Day. Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman.

Have you read the Wharton School report?

Mr. DAY. I made a good attempt at it, Mr. Keith, but I would have to qualify my answer to say that there is a lot of it that I don't recall.

Mr. KEITH. Do you know of anybody who has read it in total, personally?

Mr. DAY. No, sir; I couldn't vouch for that.

Mr. KEITH. There is more to it than just this.

Mr. MOSS. That is the report. You are talking of the mimeographed volumes which look more impressive than they are.

Mr. KEITH. I haven't read the report and I don't know anybody that has read it comprehensively except perhaps the man sitting back there, Mr. Cohen.

What has happened to your exchange as the result of institutional buying in the last 6 or 7 years?

Mr. DAY. Well, if you will permit me, Mr. Keith, I will say the Midwest Stock Exchange has been doing its best to compete with conglomerates in the stock exchange business, but as far as the institutional effect on our exchange is concerned, we find an increasing impact in this area. We have a growing amount of block orders coming in to us. They run about 17 to 19 percent of our volume now, and we use a 5,000 figure as a block, yes, about 17 to 19 percent of our business.

Mr. KEITH. What has been the total volume increase on your exchange in the last 6 years?

Mr. DAY. Perhaps I could best answer it this way from my limited memory. We ran 84 million shares last year for approximately 4 billion billion in dollar volume 5 or 6 years ago.

Mr. KEITH. What was it 6 years ago, roughly?

Mr. DAY. I would say 50 as a guess. I would be glad to supply that figure to you later.

Mr. KEITH. In dollar volume, 50.

Mr. DAY. No, that would be share volume. I would say about one billion in dollar volume 5 or 6 years ago?

Mr. KEITH. So as a percentage, what is your growth in 6 years?

Mr. DAY. I would have to get that figure.

Mr. KEITH. I would like to have those figures.

(The following information was subsequently submitted:)

MIDWEST STOCK EXCHANGE VOLUME

Year	Shares	Dollars
1967 (9 months).....	79,292,912	\$3,667,096,989
1967 (estimate).....	106,000,000	4,800,000,000
1966.....	84,747,740	3,886,892,250
1965.....	69,605,096	3,085,807,767
1964.....	50,584,823	2,286,202,056
1963.....	43,773,297	1,755,658,882
1962.....	39,738,398	1,511,814,969
1961.....	42,990,970	1,761,745,757
1960.....	31,432,388	1,235,159,894
1959.....	33,692,787	1,390,505,923
1958.....	28,473,135	1,046,931,658
1957.....	25,901,100	864,754,046

Mr. DAY. I would say this. That since we formed this exchange, the Midwest Exchange, you know it was a consolidation some years ago, I think we might still have the greatest percentage gain in share and dollar volume of any exchange.

Mr. KEITH. This sort of reinforces Mr. Moss' expressed philosophy that no matter what this committee does in the threat of the adverse impact, progress seems to continue.

Mr. DAY. I don't think there is any question that we have tremendous business now and substantial growth in our business since the long bull market. I know as the president I have been very grateful for a bull market. It makes you look good.

Mr. KEITH. I have no further questions, Mr. Chairman.

Mr. Moss. Mr. Murphy.

Mr. MURPHY. Yes. Mr. Day, I want to congratulate you on your statement.

Mr. DAY. Thank you.

Mr. MURPHY. Through whom do most of the funds buy, through what form? Do they go through members of the exchanges?

Mr. DAY. You mean the business that comes to us.

Mr. MURPHY. Yes. They buy the stock, and after they have made their minds up just which blocks they are going to buy, who do they go through to buy it?

Mr. DAY. Well, we find that they are either filled by the firm that they allocate the stock to directly, who have sold their shares, maybe half a dozen firms, or they use what is termed in our business as the "lead broker concept," where the fund may well want to give substantial brokerage business in lieu of the fact that the firm has sold its shares, rather than splitting it up in small lots and handing it to individual firms, it gives it to what is called a lead broker who fills that order and then simply sends a check to these other dealer firms. Am I approaching your question?

Mr. MURPHY. Yes. Do they pay the same commissions as the individual investor?

Mr. DAY. Yes, sir.

Mr. MURPHY. As a practice, do the funds from, say, Massachusetts, the funds from New York, the funds from Illinois buy through the exchanges in their particular areas?

Mr. DAY. Not necessarily. We would like to have a lot more business. They don't always try our marketplace, but this is no criticism against the funds, because this is also true of dual members of the New York Stock Exchange.

Our position is that we would like our market tested by a fund or a member of New York or anyone. If our price is as good or better than New York. We think that we have a good marketplace, particularly from the sell side because, as we mentioned, there would be no tax.

Mr. MURPHY. But you find that where the fund is located is where they buy?

Mr. DAY. Not necessarily; no, sir.

Mr. MURPHY. Is there any area disarrangement that you would think—I would think that probably the New York area would buy principally in New York and let's say the west coast market on the west coast.

Mr. DAY. I don't know that that is necessarily true.

Mr. MURPHY. Is there any marked imbalance?

Mr. WEITHERS. Mr. Murphy, maybe to clarify it, I think that the tremendous change in communications and improvement in communications give the funds, no matter where they are located, an opportunity to check the known marketplaces for the securities in which they deal almost instantaneously, so that there is a continuous check almost nationwide in all the recognized markets by the funds.

Mr. MURPHY. Thank you, Mr. Chairman.

Mr. MOSS. Thank you, gentlemen. I assure you that the statement you have made before this committee will be given very careful consideration. I thank you for appearing.

Mr. DAY. Thank you, Mr. Chairman.

Mr. MOSS. The next witnesses, Mr. Ronald T. Lyman, Jr., Scudder, Stevens & Clark Co., accompanied by Mr. Harry Hagey of Stein, Roe & Farnham, and Mr. Milton H. Cohen, of Schiff, Hardin, Waite, Dorschel & Britton.

Mr. MURPHY (presiding). Mr. Lyman, you can present your entire statement or summarize it, if you wish.

**STATEMENT OF RONALD T. LYMAN, JR., INVESTMENT COUNSEL
SPONSORED NO-LOAD FUNDS; ACCOMPANIED BY HARRY H.
HAGEY AND MILTON H. COHEN, COUNSEL**

Mr. LYMAN. Thank you very much, sir.

Mr. Chairman, members of the subcommittee, Dr. Stevenson, my name is Ronald T. Lyman, Jr. I am appearing on behalf of a group of Investment Counsel Sponsored No-Load Funds, a list of the members of which has been handed up to members of the subcommittee. I am a general partner of the investment counsel firm of Scudder, Stevens & Clark and president of Scudder, Stevens & Clark Balanced Fund, and Scudder, Stevens & Clark Common Stock Fund, and I am a member of the board of governors of the Investment Company Institute. Here with me and also available to answer questions about one group's position are Mr. Harry H. Hagey, who is a partner of the counseling firm of Stein, Roe & Farnham of Chicago and president of its no-load funds, and Mr. Milton H. Cohen, counsel to our group.

All of the investment companies in our group are open-end management companies and all are members of the Investment Company Institute. However, they differ from most open-end companies and most members of the ICI in that they are all "no-load" funds; that is to say, their shares are regularly offered at net asset value without a sales charge of any kind. In this and other respects specified in the law, they fall within a separate category of companies to which Congress gave special recognition in section 10(d) of the Investment Company Act of 1940.

The investment counsel firms that act as advisers to the no-load funds within our group all have these characteristics:

(1) They are registered as investment advisers under the Investment Advisers Act of 1940.

(2) They are principally in the business of rendering investment supervisory services as defined in that Act, and thus are entitled to call themselves "investment counsel" under section 208(d) thereof.

(3) They render investment counseling and supervisory services primarily to clients other than investment companies.

The oldest no-load fund in the group was organized in 1928 and now has net assets of about \$117 million. The youngest was organized as recently as 1965 and its net assets now amount to about \$1,600,000. The largest fund in our group, organized in 1950, now has net assets of about \$358 million.

Typically, the counseling firms in our group had been in business for some years before creating their no-load funds. They had been performing counseling services for their various individual clients but had found it impractical to handle small accounts on an individual basis and had therefore found it necessary to specify a minimum fee for accounts they would accept. As a result, each of them had had the experience over the years of turning down requests to serve smaller accounts. Each of the firms decided that a good solution would be to create a no-load fund as a vehicle for combining investments of these people of smaller resources who could not be economically served as individual clients but who wanted unbiased, expert investment advice.

Section 10(d) of the Investment Company Act takes the form of an exemption from the provisions of sections 10(a) and 10(b)(2) and permits an investment company meeting its special requirements to have its entire board, except for one director, consist of individuals who are affiliated with the investment adviser or officers or employees of the company itself. (Under the bill, the only change would be to substitute the concept of "interested" for "affiliated.") Among several requirements to qualify for the exemption, the critical ones are that no sales load may be charged and no sales or promotion expenses may be incurred by the investment company itself. Accordingly, there are no commissions paid to salesmen by any of the members of our group, and relatively little promotional effort. Essentially, those who have become investors in these funds have done so on their own initiative, because they wanted to get expert and disinterested services of a particular counseling firm through the medium of its sponsored fund.

Our reason for appearing today is to be sure that the particular features of our situation are not lost sight of in the exploration of wider questions. Perhaps our group should be pleased and reassured by the fact that the SEC's long report discussing the mutual fund business devotes almost no space to us. On the other hand, although there has been no suggestion that the assumptions underlying section 10(d) have proved invalid in any way, certain of the amendments that the Commission is recommending, particularly those relating to fees for management services and independence of directors, would affect us along with the rest of the industry and as a practical matter would eliminate the distinctive treatment that Congress wrote into section 10(d) in 1940. Again, although we are members of the ICI and subscribe generally to the presentation made on behalf of all of its members, we felt that we ourselves needed to bring to your attention some special impacts of the proposed legislation on the no-load group.

Obviously, we do not contend that the advisory or management fee charged to no-load funds should be other than "reasonable." The real question is how the fee and its reasonableness should be determined. Our basic position is that the fees paid by the no-load funds to their

respective advisers, while varying within our group, are all well within the range of reasonableness, and that this result is brought about and assured by the peculiarly strong competitive situation of the no-load group, so that we believe the proposed legislative changes are unnecessary. These changes, on the other hand, would upset the basic assumptions of section 10(d) and would subject the no-load counseling firms to new, unwarranted costs and risks, thereby discouraging the formation of the no-load type of fund.

For all companies within our group the maximum advisory fee is 0.5 percent per annum, or half the statutory maximum of 1 percent, found in clause (6) of section 10(d). In the case of the largest fund in the group, the 0.5 percent is charged only on the first \$50 million of net assets, then 0.4 percent on the next \$100 million, then 0.35 percent on the balance. In other cases it is 0.5 percent on the first \$100 million or \$125 million and either 0.4 percent or 0.375 percent on the balance. In still other cases no breakpoint for reduction below 0.5 percent has yet been found appropriate.

Inasmuch as section 10(d) precludes the charging of a sales load or the payment of promotion expenses by qualifying investment companies, the management or advisory fees received by the counseling firms from their respective no-load funds must absorb some kinds of expenses, including promotion expenses, that the rest of the industry can take care of as a fund expense or through the load. For this and other reasons, the aggregate expense ratio is much more significant than the fee rate alone in comparing and evaluating costs of investment management. By the "aggregate expense ratio" I mean the management fee plus all other operating expenses paid by the fund itself, expressed as a percentage of invested dollars. This ratio varies somewhat from company to company, depending largely on size, but is at a modest level for all members of our group, averaging about 0.6 percent annually or \$60 per \$10,000 of net asset value.

We suggest that management fees and total expenses are at these moderate levels today—while showing the variations they do—because competition works with special efficiency in the case of no-load funds. The investor pays nothing to become a stockholder of a no-load fund, except possibly the price of a postage stamp or a telephone call, so that he can freely change advisers by selling one no-load fund and buying another. From the investor's viewpoint these no-load funds are simply a means of obtaining counseling services of a particular firm by buying shares of its fund; thus, any dissatisfaction with services performed in relation to management fees paid, or vice versa, can be readily taken care of by switching no-load funds, and therefore advisers, without incurring any penalty. Competition works freely, limited only by legal restrictions on advertising.

Stating this another way, it is of the essence of any mutual fund that its shares are freely redeemable by the stockholder. The no-load feature of our funds makes this unusual redemption feature a doubly powerful weapon in the hands of the investor, because it permits him to get the full benefit of competition by changing managements at his complete discretion.

Congress recognized all this in 1940 when it enacted section 10(d) of the present act. For the investment company industry generally,

section 10(a) required at least 40 percent of nonaffiliation between an investment company and its adviser, and to that extent, through section 15(c), fostered arm's-length bargaining in connection with advisory contracts. But in the case of no-load funds, as mentioned before, Congress said that a single outside director was enough—obviously because the need was seen to be quite different. Section 10(d) amounted to a recognition by Congress of three essential points:

- (1) That, contrary to what is often said about fund shares, no-load fund shares are "bought" by investors rather than "sold" to them;
- (2) That an investor is really selecting the advisory firm when he decides to buy shares of a particular no-load fund; and
- (3) That there would be no point in fostering arm's-length bargaining as to the terms of advisory contracts with no-load funds because competition works freely and effectively: by hypothesis there is no deterrent to the investor's changing no-load funds if he is dissatisfied with the adviser or its fee.

We believe that Congress clearly intended, through section 10(d), to foster and encourage this type of fund. We believe, unhappily, that enactment of the present bill would inhibit and discourage them, notwithstanding that section 10(d) itself would remain virtually unchanged.

One reason lies in the crucially different roles that the outside directors play under the present law and would be expected to play under the proposed law. Under present law and practice they serve the valuable function, as in any corporation, of bringing an outside perspective to all aspects of management's handling of corporate affairs. They keep the management constantly "on its toes"; they raise questions and express viewpoints that may not occur to members of management. But, while those with whom I am personally acquainted are men of high caliber and ability and perform their role seriously and conscientiously, these outside directors hardly conceive themselves as having a special, personal responsibility to negotiate the terms of an investment advisory contract at arm's length.

Under the proposed bill, on the other hand, apart from the new requirement that an outside director be "disinterested" as distinguished from "unaffiliated," there would be a drastic change in his function and responsibility. He would have a large new burden of inquiry and judgment before he could agree to an advisory fee as "reasonable." The law would set forth a very broad, yet we think rather unbalanced, list of "factors" or criteria to be considered, plus all others that might be "appropriate and material." As to all these criteria it would be the outside director's duty to request and evaluate pertinent data and reach his conclusion as to reasonableness. In performing this complex task he would be entirely dependent on his own resources except for the adviser's furnishing data to him.

In the case of a no-load fund the required number of outside directors—that is, only one—would not be changed, but for all practical purposes the distinction written into section 10(d) in 1940 would be wiped out, even though superficially left there. I say this because it seems very doubtful that any outsider would be willing, all alone, to take responsibility for carrying out the new and burdensome functions imposed by section 15, and hence the no-load funds would be forced to ask several outsiders to share the responsibility.

Moreover, the new role of the outside director or directors would be a quite anomalous one, because the suggested section 15 contains provisions that look in quite opposite directions. On the one hand, it contemplates a greatly enlarged burden on outside directors to make diligent inquiry and apply appropriate criteria to determine the "reasonable" fee level. But on the other hand, this procedure is to be largely ignored in the ultimately significant determination of reasonableness by a court.

Nor could an outside director take comfort in the happy thought that he would not be exposed to personal liability. Although the SEC has said that it intends no personal liability, the bill as drafted would not, in our counsel's view, accomplish this result.

It seems likely that many individuals who might have been willing to serve as outside directors in the past would be unwilling—even if they would pass muster under the new "disinterested" requirement—to take on the sharply increased responsibility and risk of directorships under the new law. Those who would be willing would probably expect, and be entitled to, more substantial compensation for the much greater burdens involved. Moreover, for reasons already indicated, it would almost inevitably be necessary to have more than the minimum number. The combined effect would be that all funds would be hard put to find enough willing and qualified persons to serve, and small funds (several of which are among the members of our group) would have a new and significant expense burden.

In my prepared statement as filed with the subcommittee, on pages 13 and 14, there is some mention of two respects in which the new definition of "interested person" is regarded as unduly broad and burdensome to our type of fund. My understanding is that the agreement between the SEC and the ICI, on the various so-called secondary points in the law, would take care of these particular difficulties, so that I will omit this material from my present testimony.

In closing, what I would like to emphasize is that the bill would amount to a repudiation of the basic concept of no-load funds that had existed for many years before 1940 and that Congress accepted and fostered in the 1940 act—without any showing that no-load funds have not lived up to the 1940 expectation or that the concept was invalid in any way.

In 1940 Congress did not emphasize—it deemphasized—the role of the outside director of a no-load fund, because it regarded such a fund as being essentially a vehicle for investors to obtain investment advisory services that could not practically be made available on an individual basis. Likewise, no need was seen in 1940 to emphasize any distinction between the no-load fund and the counseling firm or to subject the management fee to special judicial scrutiny. The concept was that an investor could move freely among competing no-load funds or to other sources of investment advice, depending on his own estimate of relative benefits and costs.

Today, with no showing that this concept is not as valid as ever, it is proposed to change all this. Although nominally the basic unity of fund and adviser would still be recognized, actually there would be substituted, by enlarging and emphasizing the role of the independent director, a new concept of separateness and independence between fund and adviser. But beyond this, and even more serious, there would

be an encouragement of litigation rather than competition as the main sanction to assure reasonableness of fees.

The counseling firms traditionally have looked at their sponsored funds as a means of extending their counseling business to smaller investors, not as separate entities toward which they were in the position of independent contractors. As a matter of basic policy they make it cost-free for investors to become shareholders of the funds and cost-free to redeem and go elsewhere (except for a minor redemption charge—retained by the fund and not the adviser—in one or two instances). The firms in our group are quite happy to live in a competitive environment. They do not want stockholder-clients to join or stay on unless they are satisfied on the basis of performance and costs. By the same token, they know they must satisfy these stockholder-clients, not outside directors or any other outsider, as to the fairness of their fees in relation to services performed if they are to stay in business and grow.

It is expensive to start any mutual fund, even apart from the cost of creating an advisory staff. In the case of a no-load fund particularly, the sponsor cannot expect to achieve a profitable operation except over a very extended period of time, because there is no selling load to absorb any of the startup or promotional cost and, with no salesmen, growth is typically very slow. The sponsor depends on slow but steady growth in the number of fund stockholders who are satisfied to pay the established fee for what they receive. The whole idea would be very much less attractive to a sponsor if it were expected to deal at arm's length with outsiders and still could be second-guessed and exposed to liability and expense through the kind of stockholder litigation that would be encouraged by the bill.

For these reasons we believe there is a strong likelihood that the proposed amendments would seriously discourage the formation of new no-load funds—a result that we are sure this committee would not favor.

We appreciate very much having the opportunity to be heard by you.

Mr. MURPHY. Thank you, Mr. Lyman, for a very fine statement. I note that you have with you a Cohen, Milton H. Cohen, who was counsel to the Commission on its special study, and of course, made a number of suggestions regarding the improvement of the shareholder's position in mutual funds as well as in the market generally.

Mr. Cohen, one of the things disturbing this committee is the tremendous growth of the investment company industry, and of institutions as a whole and the resulting effect upon free markets as we have known them. Do we have free markets on the exchanges?

Mr. COHEN. We commented in the special study at great length on the growing role of institutions in the securities markets. We devoted part of our chapter VIII as I recall, to the phenomenon of increased purchases by the large institutions, and we talked about their activity as bearing on market mechanisms and the suitability of existing mechanisms to handle all that.

I think we exposed for the first time some problems that needed to be talked about and further studied, and we recommended that they be the subject of continuing studies, and I think those subjects have been receiving more attention in the last 5 years than they had received at the SEC or elsewhere in the preceding period.

Now when you ask whether the markets are free, we again commented on the concept of a free market in the special study in relation to the concept, for example, of an orderly market, and we said that anything you do to be assured of orderliness may on the other side of the coin be considered as affecting freedom of the market.

For example, the specialist system, which is the stock exchanges' main mechanism for assuring orderliness, can be considered as to some extent limiting pure freedom, if the latter term means letting a market operate in accordance with the random flow of public buy and sell orders without any intervention by anyone to keep that market orderly. So, to the extent you deliberately concern yourself with and do something about orderliness, depending on semantics I suppose, you can say that that is affecting freedom of the market.

Mr. MURPHY. Can the specialist survive in the exchange today, let's say under present circumstances?

Mr. COHEN. We found that the specialist's role had changed tremendously between 1934 when the Exchange Act was adopted, and 1962 when we made our study. I think this was brought out by some basic testimony by presidents of the New York Stock Exchange at two different times, one of whom defined a specialist as someone who handles orders for others—that was an early definition—and Mr. Funston's much more recent 1961 definition that a specialist is someone who acts as a dealer in the market. Thus the specialist role had greatly changed as the flow of public orders changed, and as blocks purchased and sold by institutions were not being handled through the ordinary mechanisms.

Now since 1962, there seems to be a further trend in that direction. I haven't had occasion to make further studies since the special study and I have no personal knowledge of this, but from what I read, it appears that the trend is more in that direction, and I would say that the specialist system has to keep adapting itself to the new uses of the market.

I read a year or so ago of a specialist himself coming in to be the main purchaser of a \$17 million block that went over the stock exchange. Now that certainly isn't the traditional function of a specialist, so you can say that the specialist concept has been changing and presumably will continue to change as the needs of the market change.

Mr. MURPHY. Mr. Cohen, we have a series of questions that we would like to submit to you and hold the record open at this time for your response to them. They will be lengthy and we are probably going to be crowded for time in just a little while, and I have some other questions for Mr. Lyman.

Mr. COHEN. I will do my best, sir.

(The following letter was received by the committee:)

SCHIFF, HARDIN, WAITE, DORSCHER & BRITTON,
Chicago, Ill., October 31, 1967.

HON. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, Rayburn House Office Building, Washington, D.C.

DEAR MR. MOSS: This is in reply to your letter of October 18, 1967 in which you posed the following questions:

"Do we have free markets? Can we have them? What is the influence of tremendous blocks being bought and sold by the institutions? What is the influence of large blocks being held off the market by institutions? Are some issues held in

large enough quantities by institutions that the issues should be delisted? Do you think that the exchanges or sales by an investment company or an institution for that matter, actually can run up or run down the price of a security? Can the specialist function amid these big block transactions?"

As you know, I answered certain of these questions orally, at pages 635-637 of the typewritten transcript, when I appeared before the Subcommittee as counsel for the group of Investment Counsel Sponsored No-Load Funds. Of course, my remarks at that time as well as the following ones are made in my personal capacity and not on behalf of such group of No-Load Funds or any other group or person.

The 1963 Report of the Special Study of Securities Markets, for which I had senior responsibility as Director, had a good deal to say, directly or indirectly, on the topics covered in your questions. I would respectfully call your attention especially to the following portions of the Report:

Part 2, pages 13-18, dealing with the concept of a "free" market in relation to a "fair" and "orderly" one, and also the concept of "depth."

Part 2, pages 128-33, 136-42, and 164-65, discussing specialists in relation to the handling of block (institutional) transactions and in relation to "freedom" of the market.

Part 2, pages 167-21, containing our conclusions and recommendations concerning specialists, of which several are somewhat pertinent to your questions, especially the following:

"9. The NYSE and Amex should undertake studies, in conjunction with the Commission, as to methods or plans by which the capacity of specialists to acquire larger blocks of stock within the framework of the auction market could be otherwise strengthened. Among other possibilities, consideration should be given to (a) the establishment of an exchange-administered capital fund from which specialists could borrow under appropriate limits and safeguards; (b) the establishment of a capital fund, through contributions from the brokerage income of all specialists, that would be administered by specialists' representatives and/or the Exchange itself and would be available for taking positions beyond the financial capacity of an individual specialist; or (c) establishment of a system of limited self-insurance by specialists as a group. Reference is made to recommendation 4 above with respect to increasing specialist capital requirement and the recommendation in part F of this chapter concerning the possibility of creating a category of 'auxiliary specialists.'"

Part 2, pages 828-31, discussing the importance of, and factors affecting, "depth" of an auction market, including the factor of increased institutionalization.

Part 2, pages 838-70, dealing with institutional participation and block transactions, especially the summary and conclusions appearing at 866-70, including the following recommendation:

"1. Institutional participation has become increasingly important in the total business of securities markets and, since the institutions tend to deal in larger blocks and for other reasons, such participation presents special problems from the point of view of the exchanges and in relation to the public interest and protection of investors. In view of the growing importance of institutional transactions and the probability that needs and problems associated with them will not remain static, it is particularly important that there be an adequate body of information about them on a continuous basis for the use of the Commission, the self-regulatory bodies and the investing public. The Commission should institute programs to obtain, and to publish on appropriately aggregated bases, more continuous data concerning institutional participation in the securities markets, including securities held, amounts of gross and net purchases over periods of time, and turnover rates. From time to time the Commission should hold conferences with, or otherwise invite the views and suggestions of, institutional investors, the principal exchanges and representatives of the securities business with regard to changing impacts of institutional transactions on securities markets, related needs of institutional investors, and questions of public policy involved."

Part 2, pages 952-61, relating to "currents of change" in the securities markets and the need for continuing study, including the following finding:

"2. Institutions have become greater participants in trading markets, particularly in respect of NYSE-listed securities, and the relatively large size of their transactions has tended to aggravate the problem of temporary disparities in supply and demand in a continuous auction market. For this reason and because

of generally 'thinner' markets, demands on the specialist system have become greater than in prior times, and greater for some securities than others."

And the following recommendations:

"1. It is essential for the Commission to improve its facilities and programs for continuous accumulation of data with respect to fundamental, but often obscure, changes in the components, uses and needs of the total pattern of trading markets; i.e., the separate markets when considered in relation to each other. This need, together with others discussed in chapters VI, VII, and VIII, calls for both a reappraisal of present reporting systems, with full regard to the burden of supplying particular information in relation to its utility in the public interest, and a considerably wider perspective as to potential uses of data processing equipment in discharging the Commission's regulatory responsibilities.

"2. The Commission should establish a separate, permanent policy and planning unit within its staff, having the responsibility of accumulating and analyzing pertinent data bearing on market patterns and practices generally, making special studies as the need may be indicated, and reviewing policies and regulations in light of changing circumstances."

Part 4, pages 844-47, dealing with institutional activity in the May 1962 market break.

What we said in the passages referred to above and elsewhere in the Special Study Report was based on voluminous statistical and other data compiled and analyzed over a period of time by a 65-man study group. On the other hand, as I mentioned at page 637 of the typewritten transcript, I personally have had neither the occasion nor the facilities to gather any similar data covering the period since 1962. Accordingly, I have no real basis to express any further views at this time on the questions posed in your letter, other than to say that it is my general impression that (i) the conclusions and recommendations that we expressed in 1963 have generally been supported and confirmed by subsequent experience, (ii) inevitably, because of implementation of Special Study recommendations or for other reasons, important changes of various kinds have taken place in the securities markets since completion of the Special Study, and (iii), of particular relevance to your inquiries, the mutual funds' and other institutions' share of ownership and activity in corporate equity securities has grown very significantly.

I would also point out in the latter connection that the 1963 Report itself, having emphasized the already evident trend toward institutionalization of the securities markets and the dynamic and changing character of such markets generally, went on to stress the need to gather relevant data on a continuous basis and to re-examine from time to time the adequacy of market mechanisms and regulatory measures in light of observed changes; see, in addition to certain of the passages quoted above, the following passage from the Special Study's first transmittal letter dated April 3, 1963 (reprinted in Part 1, page xiv, and Part 5, page 22):

"A corollary of prime importance is that broad-gaged studies of the kind undertaken by the Special Study cannot be once-in-a-generation affairs but should be a major part of the Commission's regular and continuous activities. To be able to see the forest instead of just the trees, to be able to evaluate current trends and future potentials as well as past results, the Commission should have a permanent staff group, small but expertly manned, that is free from routine administration and assigned the responsibility of observing and measuring important trends, identifying and evaluating new developments, and from time to time making special studies of particular subjects. . . ."

To the extent that the Commission has not heretofore implemented these recommendations for continuous compilation and study of relevant data (not limited to institutionalization but covering other important trends as well) I would strongly urge that it be encouraged and enabled to do so, as I believe that the kinds of questions posed in your letter do need re-examination from time to time in the public interest but are too important and too complex to be answered even by an expert body except on the basis of adequate current data. Such data might also be useful in determining whether, and, if so, in what manner, certain recommendations of the Special Study not yet implemented should be put into effect, and what additional or substitute measures may be indicated from time to time. For example, it appears from Mr. Haack's testimony on October 17 (page 590 of the typewritten transcript) that the New York Stock Exchange presently has under consideration a measure resembling one of the

alternative measures mentioned in our recommendation No. 9 on specialists, quoted at pages 2 and 3 above.

Your letter also asks for my comments on the problems outlined in the Special Study Report regarding the mutual fund industry, particularly the question of sales load and management fee. The Special Study did not really deal with the subject of management fees, its examination of the investment company area (Chapter XI, pages 89-255 of Part 4) having been limited essentially to a few topics closely related to studies undertaken by the Special Study in other areas: selling practices (including front-end loads), reciprocal business, and insider transactions in portfolio securities. On these subjects my personal views have not changed since the 1963 Report, but I should again say that I have not had the occasion or the means to examine more recent data that might be pertinent to present judgments.

Respectfully yours,

MILTON H. COHEN.

Mr. MURPHY. Mr. Lyman, as I understand your position, you are concerned only that you have to have one or two additional independent directors, and that your advisory fees which you now say are reasonable might be subject to some independent consideration. Of course, the question of additional nonaffiliated directors is one which will come up for consideration by the committee, but it is not clear yet that you advance this suggestion very seriously.

On the other hand, you do seem to be concerned about the management fee, even though as you state, your fees are reasonable, and you cannot argue against a test of reasonableness.

On page 16 of your statement you speak about the kind of stockholder's litigation that might be encouraged by the bill. I wonder if you would discuss this a little more at length, and whether you have a suggestion of how a court test of the reasonableness of fees can be secured without a great deal of litigation.

Mr. LYMAN. Well, I think that the only way that a court test can be achieved without any degree of litigation is for the company to give in. This is what has been going on in some cases. We think that it is a matter of degree here on the independent director. We wouldn't feel that under the present concept of the 10(d) companies the independent director had a necessarily special mission to agitate on the subject of the management fee, because the investor has come in without paying any entrance fee or initiation fee, if you like, and he is completely free to come and go as he chooses. Therefore, he is deemed to be capable of judging the reasonableness of the fee that he is buying. I won't say that our independent directors are not concerned with the fee. Of course they are. As good businessmen they are bound to be.

If our fees are unreasonable I am absolutely certain that we would hear about it from them. But I think under the concept of the 10(d) company there is not that special assignment, whereas there would be under the proposed law.

Mr. HAGEY. Could I comment just briefly, and perhaps add something to that?

Mr. MURPHY. Please.

Mr. HAGEY. I think all of us who have now quite well established no-load funds would recognize that if you went ahead and passed this legislation, we would live with it one way or another. We think that you would be doing some things to us, perhaps inadvertently, in attempting to deal with an overall problem which we think would be harmful.

But in terms of what I understand your question to be directed to, I would suggest that you might feel, as we know that the SEC and others feel, that there is something about investment-counsel-sponsored no-load funds that represents a pretty outstanding and different kind of a vehicle for the investor, and they would like to see more like us.

What we are saying really to you here is that if you do some of these things that would be included in this bill, require additional outside directors, require them to accept greater responsibility with a whole list of criteria spelled out against which they must test the management fee, subject them to much greater chance of litigation, in case a shareholder, whether justified or not, chooses to bring suit—and bearing in mind that no-load funds are started by an investment counsel firm from scratch, and they lose money for years, and that the only reason you start them, other than trying to oblige clients who want a place to put smaller amounts of money, is that you hope maybe someday this will be a profitable thing for you—we are saying to you that, if the rules of the game are changed, we think you discourage the formation of future no-load funds, and we doubt that this is in the public interest.

Mr. MURPHY. Do you think there would be any way, Mr. Lyman, to find out the reasonableness without going through a stockholder suit?

Mr. LYMAN. Well, I think there is the present method, which, in our opinion, is a satisfactory one and an effective one. Nobody has proved what is reasonable and what isn't reasonable, necessarily, but I think that the fact that you can attract investors with no sales force over a period of years, and have your funds consistently grow, is an indication that this is not considered an unreasonable fee to pay. This is the working of the people associated with the adviser and the independent directors, all as a complete group. If there was anything unreasonable about the management fee, I think we would hear about it from our independent directors, even though we only have to have one.

Mr. MURPHY. Have you had any complaints with the fees?

Mr. LYMAN. I would say, basically, no.

Mr. MURPHY. Have you had any suits?

Mr. LYMAN. You realize, of course, that our funds in terms of the industry are very small, and in practically every case there is already a sliding fee in existence.

Mr. MURPHY. Have there been any suits brought as far as fees are concerned?

Mr. LYMAN. Not that I know of in the no-load funds.

Mr. MURPHY. Thank you very much, Mr. Lyman. Mr. Cohen, I will submit those questions to you. Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Cohen, it is nice to see you again, and Mr. Lyman. I believe you had something to do with the SEC's "special study."

Mr. COHEN. I had something to do with the special study, yes, sir.

Mr. KEITH. I am just now reviewing the recommendations that were contained in the special study with reference to mutual funds, and you say in the concluding paragraph:

In conjunction with its comprehensive program of study of the investment company industry, the Commission should recommend to the Congress legislation amending the present provisions of the Investment Company Act of 1940 which relate to contractual plans. Consideration should be given to the abolition of any future front-end load. If it should be concluded that such abolition is not called for, such legislation should both substantially limit the amount and method of application of any such load and prohibit the offering of front-end load contractual plans by any mutual fund sales organization without the simultaneous offering of a level-load voluntary plan for shares of the same fund and (except for prepayment of selling charges) on substantially the same basis.

(Off the record.)

Mr. KEITH. Back on the record. When the SEC came out with its recommendations based in part upon a study in which you had been intimately involved, did you express yourself publicly about these recommendations?

Mr. COHEN. No, sir. I was not consulted in any manner or degree after I completed the special study in 1963.

Mr. KEITH. And did you make any voluntary observations from the public point of view?

Mr. COHEN. Not in any area involved in the present bills.

Mr. KEITH. Mr. Lyman, it is my understanding that Loomis-Sayles is one of your group.

Mr. LYMAN. That is correct.

Mr. KEITH. Is not Loomis-Sayles the one that is going to try to get into the retail business through Reader's Digest?

Mr. LYMAN. I understand that is correct. I simply saw a newspaper article on the subject.

Mr. COHEN. I understand that is true, in respect of an operation abroad.

Mr. LYMAN. It is not true domestically.

Mr. COHEN. It is not a domestic operation at all.

Mr. KEITH. Mr. Cohen, do you generally concur in the testimony offered by Mr. Lyman?

Mr. COHEN. Yes, sir.

Mr. KEITH. Isn't his testimony in direct opposition to some of the special study's proposals, about which I was asking you?

Mr. COHEN. I don't believe there is anything in Mr. Lyman's testimony that is in the slightest degree inconsistent with anything in the special study.

What we focused on mostly in the special study regarding mutual funds was selling practices, and of course the group I now represent, the no-load group, does not have salesmen and doesn't engage in selling in the sense that was being talked about.

In the Special Study we also commented particularly on the front-end load, but the group I represent here is about as far away on the spectrum from the front-end load as you can get, so I don't believe there is anything that we are now saying that is at all inconsistent.

Mr. MURPHY. Excuse me, Mr. Cohen. Mr. Keith, those are the second bells, and I am afraid we are going to have to go to the floor. Would you like to submit some questions in writing to Mr. Cohen?

Mr. KEITH. It is your intention to stop the hearing now?

Mr. MURPHY. That is right. We are going to adjourn until tomorrow morning at 10 o'clock in room 2123.

Mr. KEITH. Well, if I have any further questions I will submit them. I don't want to leave Mr. Cohen or the hearing with the impression that there is a difference of opinion. I am just seeking the facts here, and I certainly thought that the front-end load was mentioned in your testimony?

Mr. HAGEY. There is no reference to it.

Mr. LYMAN. In my testimony?

Mr. KEITH. Yes.

Mr. LYMAN. None.

Mr. KEITH. Is not a front-end load contemplated in the Reader's Digest operation?

Mr. LYMAN. My understanding is that there is a load but it is in a European operation. It isn't a front-end load, Mr. Keith. As I say, my only information is the newspaper.

Mr. KEITH. It is not a front-end load?

Mr. LYMAN. No. It is a load.

Mr. KEITH. It is a contractual plan, is it not?

Mr. LYMAN. That I don't know. I just thought they were selling shares with a load abroad. We can find out. We have a representative from Loomis-Sayles here.

Mr. HAGEY. Sir, I am advised by a nod from a representative of Loomis-Sayles that it is not contractual.

Mr. LYMAN. It is not a contractual plan. It has a load but not a front-end load.

Mr. COHEN. In any event, that aspect of Loomis-Sayles business is simply not involved in the presentation today of a group of no-load funds sponsored by investment counsel firms.

Mr. KEITH. And the recommendations contained in the Special Study are, insofar as mutual funds are concerned, consistent with those that you are supporting here today.

Mr. COHEN. I am confident there is no inconsistency whatsoever.

Mr. KEITH. Thank you, Mr. Chairman.

(The following letter was received by the committee:)

SCUDDER, STEVENS & CLARK,
Boston, Mass., November 3, 1967.

HON. HASTINGS KEITH,
House of Representatives,
Washington, D.C.

DEAR MR. KEITH: This is in reply to your letter of October 27, 1967, addressed to our group of Investment Counsel Sponsored No-Load Funds, among others. Question 11, the only one addressed to our group, reads as follows:

"What changes in the proposed legislation may be necessary to accommodate and encourage no-load funds?"

The changes that we consider necessary for this purpose (apart from the changes in so-called "secondary" proposals that have been agreed to by the Securities and Exchange Commission and the Investment Company Institute) are as follows:

1. All of the members of our group are within the category of companies for which Congress made special provision in section 10(d) of the Investment Company Act of 1940. We are not in a position to speak for or comment about the rest of the industry, but we strongly feel that, as applied to companies qualifying under section 10(d), no need has been shown for amending section 15 in the manner proposed in H.R. 5910. In particular, proposed new subsection (c) of section 15 would amount to abandoning the concept of no-load funds embodied in section 10(d) and, for reasons summarized in my testimony on behalf of our group, would be the single most important obstacle to our type of no-load in-

vestment company. Therefore, our primary suggestion is that, if section 15 is amended in anything like the fashion proposed, there should be an express exemption for section 10(d) companies, at least from the proposed new subsection (c).

2. The list of criteria of reasonableness set forth in proposed paragraph (2) of subsection (d) of section 15 of the Act seems to us to be very one-sided and unbalanced. For example, although the Commission had suggested in its Report on Public Policy Implications (at page 145) that reasonableness should not be measured merely by "the cost of comparable services to individual investors" or "the fees charged to other externally managed investment companies," it failed to list either of these two important factors in proposed paragraph (2). We believe that if anything like the proposed section 15(d) is adopted and made applicable to section 10(d) companies, paragraph (2) should be omitted entirely.

3. The new requirement in proposed subsection (a) of section 15 that compensation for investment advisory services and for all other services be stated "separately" would also present particular difficulties for section 10(d) companies, in light of the circumstances that (i) the counseling firms that render advisory services to them are primarily in the business of rendering counseling services to other clients, so that unusual allocation problems are presented, and (ii), by reason of restrictions contained in section 10(d) itself, the management fees paid by the no-load funds must absorb some kinds of expenses that the rest of the industry can take care of as a fund expense or through the load. Since the Commission's Technical Statement indicates (at pages 4-5) that this new treatment in subsection (a) is essentially in aid of provisions of paragraph (2) of subsection (d) that we suggest be deleted in any event, we believe that the proposed requirement to state compensation "separately," if adopted for other investment companies, should not apply to section 10(d) companies.

4. While the subject is not directly involved in the proposed legislation, we believe that a further measure to accommodate and encourage no-load funds would be to liberalize somewhat the present "tombstone ad" requirements. It is not apparent to us why further relaxation could not be accomplished within the existing statutes, but if the Commission feels that its present rule 134 goes as far as possible without statutory amendment, either a broadening of present section 2(10)(b) of the Securities Act of 1933 or a special provision in the Investment Company Act as to advertisements of investment companies might be needed.

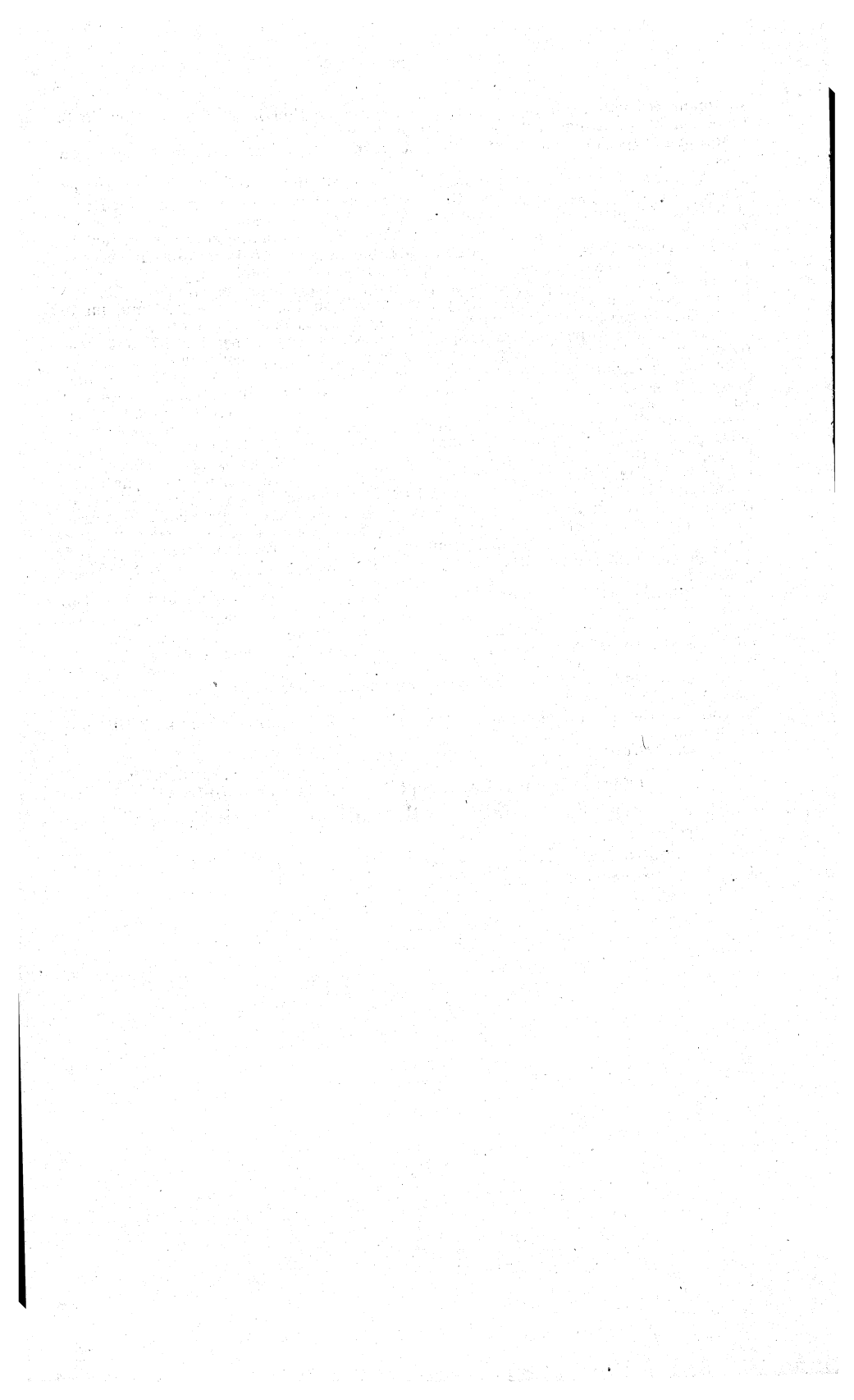
Respectfully yours,

RONALD T. LYMAN, Jr.

(For the group of Investment Counsel Sponsored No-Load Funds).

Mr. MURPHY. The committee will be adjourned until 10 a.m. tomorrow in room 2123.

(Whereupon, at 12:30 p.m., the subcommittee adjourned, to reconvene Wednesday, October 18, 1967, at 10 a.m.)



INVESTMENT COMPANY ACT AMENDMENTS OF 1967

WEDNESDAY, OCTOBER 18, 1967

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCE AND FINANCE,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 2123, Rayburn House Office Building, Hon. John E. Moss (chairman of the subcommittee) presiding.

Mr. Moss. The committee will be in order.

We are very pleased to introduce our first witness this morning, who appears at the request of the committee, Prof. Henry C. Wallich, professor of economics, Yale University. Professor Wallich.

STATEMENT OF HENRY C. WALLICH, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. WALLICH. Mr. Chairman, I understand it is agreeable to you if I summarize my statement.

Mr. Moss. Certainly it is. We will receive your statement for the record, and you may summarize it.

(Mr. Wallich's prepared statement follows:)

STATEMENT OF HENRY C. WALLICH, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

CAN THE MUTUAL FUND BUSINESS BE IMPROVED?—THE INVESTMENT COMPANY AMENDMENTS OF 1967

The economics of mutual funds reach far. Judgments must take into account distant ramifications and allow for exceptions if they are to avoid being contradicted by particular instances. It is safe to say, however, that the growth of mutual funds has on the whole been beneficial to their holders and to the economy. The issue before your Committee, as I see it, is improvement, not reform.

Holders have benefited, for the most part, by a good rate of return. In times when inflation falsifies the true return on fixed dollar claims, mutual funds have made it easier for the small investor to hold common stocks and have given him shelter against this form of loss. Mutual funds protected him against some of the risks of stock ownership by offering a degree of diversification that he could not have easily and cheaply attained on his own.

The economy has benefited by an increased demand for equities. While the stock market does little in the way of providing capital for business, it does indirectly encourage business investment if it lowers the cost of capital. A high price-earnings ratio for common stocks is the analogue of a low interest rate on bonds. It enables businessmen who are alive to their cost of capital to reach out farther for investment opportunities than they could at a higher cost of capital, even if they do no new stock financing. With price-earnings multiples almost doubling compared with the late forties, this cheapening of investment funds must have stimulated business investment in plant and equipment, even though bond rates and mortgage rates are probably higher because money has

gone into stocks. In promoting this trend toward a lower cost of capital for business, the growth of mutual funds can claim a share.

The spread of stock ownership through mutual funds has improved the distribution of income and of wealth. It has strengthened the foundations of our private enterprise system, even though we are still far from a true People's Capitalism. These are important achievements.

Mutual funds have been good also to the securities industry. This, too, is grounds for satisfaction. The industry is a valuable part of the American economy. Its welfare is important, as is the personal welfare of the individuals that draw their living from jobs in the industry.

Nevertheless, a reader of some of the literature that is building up around these hearings is bound to feel some concern over the role that consideration of welfare of the securities industry may play in any new legislation. It is in the nature of things that a large part of the literature should be coming from the industry. They must defend their interests, and they are doing so very ably. But this should not obscure the fact that the chief objective is welfare of the mutual fund investor and of the entire economy.

Without implying criticism, it is pertinent to recall what the role of Government has been whenever it has concerned itself with competition in an industry that is not perfectly competitive. It has started out to protect competition, and ended by protecting competitors.

Some such danger seems to loom in the present case. Hopefully, and quite probably, the securities industry will ultimately benefit from an improvement in mutual funds legislation through broadened public acceptance, greater stability, enhanced competitiveness. But the issues cannot be discussed principally from the point of view of how they would affect the industry.

Areas for improvement

If ownership of mutual funds is predominantly good, it is pertinent to ask why changes should be proposed. At least temporarily, these changes could in some cases lead to persons not buying shares they would otherwise have bought. One answer is that investors may believe themselves to be buying something that in fact they are not buying, such as superior market performance. This applies particularly to the advisory fee. A second is that even very desirable results may be bought at too high a price. This applies, I believe, particularly to the sales load or sales charge, and to the front end load. Finally, a desirable activity may produce side effects, that are not desirable. This applies to the heavy trading activity, to the resulting speculative climate accompanied by potential market instability, and possibly the excessive absorption of human and material resources into stock market activity.

I shall take up these matters in the foregoing order.

Advisory fee

The Securities and Exchange Commission believes that the advisory fee paid by mutual funds to their investment advisers is in many cases too high, and recommends that it be subjected to standards of reasonableness. The Commission bases its case partly on comparisons with the cost of other ways of investing in common stocks, and partly upon the failure of economies of scale to be reflected in many of the fees. The industry, through various spokesmen, has replied that the fees actually charged are lower than the Commission thinks, do not compare unfavorably with completing media, and do reflect economies of scale. The difference here is partly one of presentation of statistics, partly of proper choice of comparisons, partly even of semantics. In my view, the Commission's way of summarizing the complex facts is substantially right in terms of what it is proper to compare and what data to use. Neither side, however, seems to have considered the conclusion that seems to emerge from the studies of technicians that the true value of investment advice is on average virtually zero. This follows from the "random walk hypothesis" that has become familiar through numerous academic writings of recent date.

The random walk hypothesis,¹ strictly speaking, has been discussed and empirically tested principally with respect to the influence of past movements of the stock market upon subsequent movements, i.e., with the effect that chartists believe themselves to be exploiting. The evidence strongly suggests that there is

¹ See Paul H. Cootner, editor, *The Random Character of Stock Market Prices*, MIT Press, 1964.

no such influence of past movements. The random walk hypothesis can be extended to all past events on somewhat restrictive assumptions that in practice are likely to be met only in part. The theory is supported, however, by frequent findings that randomly selected portfolios on average tend to do as well as or better than the average of mutual funds.² The random walk hypothesis says that, in a perfect market, all past events that could possibly influence the price of a stock have already been discounted by the market and that the next move is therefore entirely unpredictable. The chances of an upward or downward move, to be sure, need not be equal. If there is a long run upward trend, as there appears to be in the stock market, the upside chances are always a little better. But, according to this theory of complete discounting of all that is known, and subject to the respective probabilities, neither research into the company, nor the industry, nor the whole economy, nor chart reading, would enable one to predict the next move, or any thereafter, better than a random guess.

Implied in this hypothesis is that the market responds instantaneously to news. Only then will those who have the news not be able to buy a stock before the news becomes discounted. Implied also is that such forecasts as are made are not self-fulfilling, i.e., that a fundamentally unfounded belief that a stock will go up does not lead to a large amount of buying that does put it up. Neither condition is fully verified by today's markets. News does not travel instantaneously, and investors, especially fund managers seem to watch and follow each other in a way that makes some professional's forecasts self-fulfilling.

Furthermore, although I have no statistical basis for saying so, it is my belief, based on some 30 years acquaintance with the stock market, that there are a few superior individuals who do see farther than the rest. They therefore can discern and act on factors that the rest of the market has not yet seen and discounted. They can then turn in a consistently superior performance. Occasional superior performance, it hardly needs adding, is commonplace. Somebody must always be holding the stocks that are going up. Only consistency can be accepted as evidence of possession of really superior powers.

But even of those rare individuals of this caliber whom I have been privileged to know, one of whom wrote what was long the leading textbook in stock market analysis, I fear I cannot say that they permanently escaped the law of the market. The market learned their methods, and used them until stocks again by and large tended to sell for what the best judgment thought they were worth. When discounting has been pushed to that point, the best judgment can do no better. When large numbers of investors are seeking out stocks undervalued by some standard, there will cease to be undervalued stocks. When everybody is buying growth stocks, these will sell at a price that makes them no more attractive than other stocks.

This mechanism appears to be what prevents mutual funds from doing better than random choice. Studies I have seen by Irwin Friend and Douglas Vickers, by William Sharpe, and recently a Ph.D. dissertation by George Douglas at Yale have all shown that mutual funds on average do not do better and usually do worse than random selection. This proposition, which for academic purposes would have to be stated subject to certain technical qualifications, cannot be refuted by comparing the rise of particular funds with each other, or with that of any of the averages. Aside from the fact already mentioned that we are speaking of average performance, proper measurement requires that risk be taken into account. Different funds deliberately seek different degrees of risk. They are thus not comparable in terms of their capital gains and current income alone.

Risk is usually measured by the variability of a portfolio, i.e. by the dispersion or range of its rate of return, taking capital gains and current income together. When risk is so measured, it turns out that indeed the mutual funds that accept higher risk have on average a higher rate of return. But it is also shown that an average of randomly selected portfolios will usually have a higher rate of return for a given risk, or a lower risk for a given rate of return, than mutual funds.

George Douglas' dissertation showed something else. There is available a technique, worked out originally by Harry Markowitz, which enables a portfolio manager to reduce his risk for a given rate of return, or achieve a higher return

² For econometric studies of mutual fund performance, see Irwin Friend and Douglas Vickers, "Portfolio Selection and Investment Performance," *Journal of Finance*, September 1965, pp. 391-415; William F. Sharpe, "Mutual Fund Performance," *Journal of Business*, January 1966, pp. 119-138; George W. Douglas, *Risk in the Equity of Markets: An Empirical Appraisal of Market Efficiency*, Yale Ph. D. dissertation, 1967, especially pp. 45-53.

without having to accept a higher risk. The technique consists in isolating securities that move independently of, or even counter to, the market. It rests on the fact that a portfolio in which all stocks move in the same way is no better diversified than any single one of these stocks. If this seemingly simple principle were widely practiced, its usefulness, like that of all other stock market techniques, would of course disappear. Independently moving stocks would be pushed to high prices at which they could cease to have special attraction. But Douglas was able to show that the market does not avail itself of this technique, although some superior investors may do so. This finding, aside from its technical interest, further helps to dispel belief in the superiority of most professional management.

(Those who find it difficult to believe that there should be no pay-off to the vast mass of research that Wall Street pours into the securities market may want to consider also some specific disabilities under which the mutual funds labor. One of them is that their big cash inflow comes when the market is high than when it is low. They therefore tend to buy more securities when the market is high than when it is low. This is inverse dollar averaging. It leads to paying a higher than average price in the course of a market fluctuation. (One of the few good techniques that are open to an investor with a stable cash flow is real dollar averaging—investing the same amount periodically and thus buying more shares when they are cheap than when they are dear. This technique, too, would of course be neutralized if enough investors had the means to follow it.)

A second disability of the larger funds is that they can obtain worthwhile positions only in the stocks of larger companies, and tend to put prices up against themselves when they buy aggressively. Another side of this is the apparently deliberate use, in some cases, of such buying power to run up prices.

A third is the desirability, for purposes of salesmanship, to show a good position in the most lately popular stocks. One must hope that there is no truth to the story of the salesman who complains to his manager that prospects won't buy the fund because it has no XYZ stock, whereupon the manager a few days before statement days buys himself a position in XYZ at top prices. But one cannot be sure.

If evidence is desired of what some market professionals think of the value of some professional management, there are the closed end investment funds. Their shares are selling in the market like any other stock at a freely fluctuating price. They provide the same kind of management—sometimes by the same individuals—as mutual funds. With few exceptions the closed end funds sell at substantial discounts from the market value of their portfolio, of the order often of 20-30 percent and even more.

This cannot be explained on the grounds that their purchaser buys some unrealized appreciation in which he has not participated but on which he must pay the tax when the gains are realized. The asset value of these funds would have to consist entirely of unrealized appreciation to justify a discount of at most 25 percent at present tax rates. Moreover, there is the prospective reduction in capital gains tax liability that results from the lower price of the stock when it goes ex its capital gains dividend. The fact is that, where there is no sales pressure, the market puts a negative valuation upon investment management. The unexploited availability of investment management at a discount naturally raises a question regarding the justification of a substantial advisory fee for mutual funds.

Needless to say, a fund will always have expenses connected with its operations. For these it must charge. The SEC data show that the nonadvisory expenses have varied widely, with a median of .09 percent. In some cases operating expenses appear to be covered out of advisory fees.

What has been said so far applies logically to all investment advice, not just that paid for by mutual funds. On average its result are unlikely to be better than random choice, its value therefore very low or zero. This does not mean that the individuals engaged in investment analysis are not in general very able people, doing a competent job. But by the nature of their work they all—excepting possibly a very few superior people—tend to neutralize each other. It is much less meaningful, therefore, to compare the level of mutual fund advisory fees with other fees, than to raise the question how far any of these fees are economically justified. In any event it seems clear that whatever can be done without undue interference with the market to bring down mutual fund advisory fees, as the Commission proposes, will be a step in the right direction.

On the manner of implementing this proposal I would like to limit myself to the following observations. The best method of correcting a price that for some reason seems unjustified is always to get the market itself to go to work. In the present case, one would suppose that the market would do the job if enough buyers of investment advice came to realize that they are trying to buy something that in the nature of things is ordinarily not to be had. But this realization is unlikely to come from abstract reasoning. It is much more likely to result from repeated demonstrations that carefully selected portfolios are no better than randomly selected ones. That this suspicion is dawning now on a lot of investors is evident from the growing demand for periodic evaluation of investment performance, something almost unheard of in former times. But these evaluations, even when correctly done, taking into account risk, which is rarely the case, have an unfortunate consequence. The advisory and investment management organizations feel impelled to improve their performance by more frequent switching. While this is unlikely to improve their results, it does lead to very heavy trading, instability of particular stocks, and potential instability of the whole market. Thus the normal means of bringing about the correction of a disequilibrium price seems to be attended in this instance by high social costs. It may, moreover, take a long time before investors, who inevitably look at individual, non-average cases, convince themselves of how poor are their chances of finding one of the rare superior individuals to advise them and thus having better than average prospects.

Thus in the case of mutual funds, it seems desirable to follow the line of approach that the Commission is proposing.

The sales load

The Commission proposes to put a ceiling of 5 percent on the sales charge (expressed as a percentage of net value invested), equal to a sales load of about 4.76 percent (expressed as a percentage of gross amount paid). For the numerous funds now quoting a sales charge of 9.3 percent or sales load of 8.5 percent, this would involve a substantial reduction.

The industry has replied that this involves a form of public utility type regulation that is unwarranted in a competitive industry. If enacted, the arbitrary reduction in sales load would cut the margin available for the underwriter, the distributing retail dealer, and the salesman. Many distributing firms would be seriously hurt, some would go out of business, fewer salesmen would sell funds, the investor would end up owing fewer shares, mutual funds would cease to grow rapidly.

Of these possible consequences the weightiest appears to me the prospective reduction in the number of shares reaching the investor. It is plausible that at least in the short run this would be a consequence of a lower sales load. It seems generally recognized that mutual funds are sold, not bought—else why should closed end shares go begging in the open market at a discount? A lower volume of sales would hurt the investor and the economy, although it is impossible to say how much. No one knows whether investors ceasing to buy mutual funds would cease to save altogether, or save in fixed dollar claim form, or perhaps even buy stocks in some other way. A survey of buyers of front end load funds indicated that about 75 percent would not buy common stock in any other form. These buyers, however, are subject reportedly to particularly vigorous salesmanship.

The possible injury to the industry likewise deserves attention, although it does not strike me as the primary consideration. These effects have been analyzed in some depth by the industry and by the Commission staff. Since the analysis deals with the effect of all the Commission's recommendations, their discussion will here be postponed.

Though a sales load of 8.5 percent sounds high, there would be no basis for public intervention in the pricing process, provided the industry were competitive and buyers had adequate information. On both scores, however, the industry falls short of perfection: it relies on government enforced price maintenance at the retail level, under Section 22(d) of the Investment Company Act, and the product it sells contains a good admixture of hope along with information. There is opportunity for competition at the top: underwriters are free to set, and do set, any sales load they choose. Some choose zero. The industry seems strongly opposed, however, to introducing competition at the retail level, which otherwise would seem to be the obvious answer to the problem of possibly excessive sales loads. The Commission supports the industry in this regard.

It is important to examine the competitive situation at the top, because this may give a clue as to what would happen at the retail level if price maintenance were removed. The existence of what appears to be a very high sales load suggests that competition is not very active. The industry claims that the load has been coming down, not by reduction of the maximum rate charged, but by such devices as cumulated purchases becoming eligible for volume discounts and load-free reinvestments of dividends. The SEC thinks that the trend of the sales load is more correctly described as upwards. Industry representatives argue that many transactions at the top load rate are so small that the underwriter loses money, unless they are followed by repeat orders of larger size. Indeed some underwriters lose money on their overall underwriting operations. They may recoup, however, on advisory fees and, directly or indirectly, on brokerage commissions.

The fact seems to be that sales effort tends to be pushed to the point where the marginal transaction leaves no profit, no matter how high the sales load. There is then no strong reason why the sales load should change in response to competition, no matter what its level. The same conditions might prevail if the load were 10.5 percent, or 12.5 percent, except that the total volume of sales would be enlarged by an even greater number of even smaller transactions.

If this interpretation is approximately correct, it would follow that competition may exist at the wholesale level, even though it does not lead to a decline in the sales load. It is a competition to attract salesmen more than to attract investors. It tends to push up the reward paid to salesmen, so that the sales load does not come down or may even tend to rise.

If there is some tendency toward competition at the wholesale level, there is no reason to assume that it could not exist at the retail level. At present, however, competition at the retail level is prohibited under retail price maintenance. Thus it seems likely that retail price maintenance is not an empty gesture, but is effective in preventing a competition that would otherwise exist.

The conclusion that retail price maintenance is important is confirmed by two additional considerations. One is that the offer of an identical product at a lower sales load is more likely to make the buyer switch salesmen than would the offer of product that is merely similar. To be able to buy fund A at a 4.5 percent load instead of 8.5 percent is a strong competitive argument, whereas Fund B at 4.5 percent instead of Fund A at 8.5 percent may not be. A second consideration harks back to the pre-1940 history of the mutual fund industry. Intensive competition then apparently prevailed, which led to the establishment of price maintenance through the Investment Company Act of 1940.

Terminating retail price maintenance and allowing competition instead of regulation to determine the sales load may involve unforeseeable consequences. On the other hand, if price maintenance is continued, a good case exists for regulation of an industry that in one important phase of its operation is not competitive.

Before the grave step toward regulation is taken, however, it is well to examine in more depth whether the termination of price maintenance would really lead to the chaotic conditions some members of the industry predict. It is claimed that a "bootleg", i.e. free, market would then arise in which investors wishing to redeem could sell their shares at slightly more than the current market value which the fund itself offers. The shares would then be resold for less than what the fund would charge (including sales load). Such a market which would be perfectly legitimate, would obviously be beneficial both to investors who redeem and who purchase. The fund would lose the sales load on the shares turning over in the market instead of being reissued by it. The industry appears to believe that net sales also would suffer, presumably because the availability of shares in the market would drive down the sales load and reduce the interest of distributors and salesmen in pushing new sales. In that event, it is argued, funds might at times face an excess of redemptions over sales. While this would mean a shrinkage of the funds' assets, it would by no means mean a major crisis, since the funds' assets have a ready market. While funds as a group apparently have rarely if ever in recent years been net sellers of stocks for any length of time, such a condition ought to be no calamity. It would tend to depress the stock market, but orderly selling should be capable of being absorbed.

Industry sources also seem to believe that ending price maintenance would give a competitive edge to those funds that maintain their own sales organizations currently representing some 40 percent of the industry's assets. These funds would be able to prevent their salesmen from cutting the load, i.e. could exert

internal price maintenance. While this might imply a major competitive readjustment, it is not clear that the gains to investors would not make it worthwhile.

It is claimed further that reduction of the sales load would encourage investors to switch among funds. This could of course happen whether the load was reduced by removal of price maintenance or by regulation. Funds with unfavorable investment results would suffer net redemptions. They would be impelled to improve their performance by more active trading with the attendant greater instability of markets. While these results are possible, the magnitude and gravity of the consequences seem to add only very moderately to the case against ending price maintenance.

The issues in the area of sales load may be summarized as follows:

1. The mutual fund industry now enjoys a partial shelter from competition, i.e. at the retail level, through price maintenance. This creates a *prima facie* case for regulation of the sales load, although the case must be buttressed by evidence that profits of the underwriter, adviser and broker, often the same party, are excessive, or that costs are unreasonable compared with the cost of other means of buying securities, and in terms of the service rendered by the seller.

2. Removal of price maintenance would end the case for regulation. This solution would be far preferable to regulation, if it does not produce excessively harmful repercussions.

3. Both regulation of the sales load and termination of price maintenance may reduce the volume of mutual fund sales, although the extent is very uncertain and would depend, in case of regulation, on the maximum sales load fixed. If the reduction is large, the injury to investors who no longer receive the attention of salesmen and cease to buy mutual funds would have to be counted up against the gain to those who continue to buy. If the reduction should be so large as to materially influence the level of stock prices, this broader implication for the welfare of stockholders and the economy would also have to be considered.

In my personal judgment, an alternative approach that would be worth examining is to remove retail price maintenance. If this is judged too severe, or too fraught with uncertainties, the level of retail price maintenance might be cut to, say five percent. Flexibility might be allowed for subsequent further reductions.

Front end load

The Commission's recommendation that the front end load be abolished raises the same issues discussed in connection with the regular sales load, but in a much intensified form. The basic issue again is whether a whole group of potential buyers of a useful service or product should in effect be deprived of the opportunity to acquire it because a minority of this group is subject to exorbitant selling costs and possibly to more serious abuses.

The front end load is a means of selling mutual funds to "investors" on so small a scale as to justify the salesman's time only if periodic subsequent purchases are made without further selling effort. Since the salesman's work is done at the beginning, he must be paid at that time. Potentially the payment could be financed by the salesman's employer. This, however, would require working capital which some employers do not have, who would then have to drop the business. Alternatively, the salesman's compensation can be taken out of the early installments. In that case the cost becomes wholly disproportionate to what the investor buys during this period.

A similar situation exists in life insurance. To many persons, however, the value of insurance is likely to be higher than the advantages of mutual fund ownership. A certain analogy can be seen also with respect to small loans, where very high interest charges have been made legal in many states. Again, however, the benefits of these loans in many instances will be greater than fund ownership.

The purchase of a contract may induce individuals to save who otherwise would not do so. This seems broadly desirable. The front end load, by imposing a penalty on discontinuance, strengthens the incentive. The high lapse and redemption ratios presented by the Commission nevertheless indicate that these inducements have only limited power. There are other ways, moreover, in which an individual can impose upon himself an even more powerful discipline to induce saving, such as insurance or savings bond payroll deduction.

Given the modest circumstances of most buyers of front end load plans there is a question how many of them ought to be stock owners in any event. Insurance and some fixed dollar savings come before stock ownership.

The high combined lapse and redemption ratios indicate that many buyers are sold who should not have been sold. Not all lapses and redemptions mean losses, however. But all lapses and redemptions point to the high cost of what is bought ranging from a sum equal to the amount of savings actually invested (at 50 percent load) to at a minimum about 10 percent if the full plan is adhered to.

Losses imply an excess of payments over liquidated value. Data from a sample of four funds presented by the industry show that the percentage of plans terminated with a definite loss ranges from 3.5 percent to about 33 percent for these four funds. However, the data understate because the plans listed as still active probably contain some number of plans that eventually will end with a loss. The loss per account is modest, of an order of magnitude of \$100, according to industry statements. Aggregate losses are small, while aggregate realized and unrealized gains are very large. The overwhelming predominance of aggregate gains over losses reflects to some extent the rise in the stock market, a factor that cannot be counted upon with assurance.

The basic question is how far the gainers would be injured by measures designed to protect the losers.

It should be noted that in the front end load area, the Government has already enmeshed itself in regulation, since the Investment Company Act limits the first year load to 50% and the overall load to 9 percent. The issue therefore is not one of favoring regulation in principle or objecting to it. It should also be noted that the industry apparently is satisfied with this regulation and does not in general seem to argue that free unregulated competition could be trusted to take care of this particular problem.

Enough evidence has been presented by the Commission to make plausible that some changes are desirable in the front end load area.

Two possible solutions might be explored as alternatives to, or modifications of, the rigorous approach chosen by the Commission.

1. A reduction of the permissible front end load to 20 percent. This would make the first year's load little more than twice the usual 8.5 percent load. If the dealer puts up another 10 or 20 percent, which he would recover from future installments, the compensation to the salesman would not be much less than at present. The range of prospects who would be given an opportunity to buy mutual funds would be reduced only moderately.

2. Leaving the present load unchanged but requiring some compensation to be made to holders who redeem at a loss. The cost of this could be charged partly to the salesman, which would encourage him to be more selective. The rest would have to be borne by the dealer and perhaps the underwriter, again encouraging a more conservative selling approach.

Concluding remarks

It may be helpful to the present legislative effort to view the stock market and the mutual fund industry in terms of the broader evolution of our financial system.

One of the principal trends in this evolution has been the advance of institutionalization. This has meant the growth of intermediaries that convert the primary obligations of particular borrowers into assets more convenient to hold for particular investors. In the market for corporate bonds, it has made possible the raising of capital with a minimum need for appeal to individuals. The bond market in this way has become a mass production operation functioning with low turnover, low costs, and yet indirectly providing high liquidity to individual savers through depositary institutions.

Mutual funds have initiated a similar development in the stock market. The stock market is still predominantly the domain of individual investors, as the bond market once was. The amounts of new money that it raises are minute compared to those raised by the bond market—in 1966, \$2.5 billion of stock against \$15.6 billion of corporate bonds alone. The gross income that the securities business draws from commission business and other activities related to stock transactions probably exceeds the amount of money raised for industry via new stock issues. As a money raiser the stock market is extremely inefficient. Most of its operating cost must be allocated to the provision of liquidity, if indeed it can be said to have a productive function.

Mutual funds in the course of time probably will make the stock market more like the bond market. Perhaps the amounts of new capital raised in it will never be very large, since industrial equity money comes largely from profit retention. But mutual funds can provide liquidity to individual investors much as commercial and savings banks do, without need to turn over primary securities.

This evolution can be viewed as desirable and also as probable because it follows a pattern that has been tired and that is economical. The special character of common stocks, with their speculative attraction, will probably impede a fully parallel development. But the general direction may turn out to be the same. Problems of voting control would have to be solved, perhaps by limiting the percentage of the total votes that may be represented by mutual fund votes. This could be made to ensure any desired degree of noninstitutional stockholders' control.

At the present time, however, while already acting as important intermediaries, mutual funds are far from performing the function of reducing the turnover of primary securities. They are adding to this turnover, and are probably making the stock market less rather than more stable. This is not the pattern of the bond market. It is a very expensive way of meeting the very limited purposes it serves. In trying to create a legislative framework within which the mutual fund industry can freely evolve, thought should be given to ways in which the pattern traced successfully by the bond market can be transposed, with appropriate modifications, to the stock market.

Mr. WALLICH. I would like to say that it is a great honor to appear before this committee. I have had a practical interest as a security analyst in the stock market for something like 30 years, and from that vantage point I have the firm conviction that mutual funds are a good thing for the American people. If they didn't exist, they would have to be invented; particularly in an age of inflation, here is a way in which relatively low-income people can participate in growth, and can protect themselves against inflation. If what I am going to say may sound critical in some respects of the funds it is simply selecting some negative aspects. It does not mean that I am critical of the whole institution of mutual funds.

The areas for improvement that have been picked out by the Commission are the advisory fee, the sales load, and the front-end load. I would have a few more to add to these; for instance, the problem of whether the funds are creating an unnecessarily speculative climate.

On the advisory fee, the Commission argues that it is too high. They present data to support this. These data are controverted by the industry. As always, it is a matter of how to read statistics and what statistics to read. My judgment is that on balance the interpretation put upon the data by the Commission is much more nearly right than the interpretation put upon them by the industry, able as their presentation has been. I think the Commission is right in asserting that charges are too high.

But one can go one step further. If the charge were related to performance rather than to the mere fact that a mutual fund with diversified risk is being offered, then one ought to measure performance and see if mutual funds really do better than random selection. A good deal of evidence has accumulated lately that that is not the case. In other words, throwing darts at the stock market page on average over a period of time gives about the same results.

Now this has to be understood in a very precise way. One has to compare portfolios of the same degree of risk. It is no use comparing a portfolio of relatively stable stocks with a portfolio of high flyers. In the comparable case, the evidence seems to show, on the basis of a pretty exhaustive econometric tests, that on average in the long run mutual funds for the same risk have no better return, and for the same return have no less and often more risk, than randomly chosen portfolios.

This means that it is no use comparing mutual funds with the Dow-Jones average or any other average, because that leaves out of account

the risk factor. The risk factor can best be measured by the spread over which the securities fluctuate. The wider the fluctuation, the wider the risk. It appears that the rapidly moving stocks are the wide risk, wide fluctuation stocks. It is therefore quite possible to put together a fast moving portfolio. If the risks do not have the consequences they might, this portfolio will do better than a lower risk portfolio. That is the simple consequence of the fact that investors dislike risk. They put a premium on safe stocks and they put a discount on high risk stocks. If one is willing to accept risks, one can buy fast growth high return stocks, and do well so long as nothing happens.

Mr. MOSS. Professor Wallich, would you prefer to complete your summary in advance of questioning or would you like to discuss as you move along?

Mr. WALLICH. I would be perfectly happy to do the latter, assuming that after we have taken say one-third of the time on this topic, if that is your pleasure, we could go on to the next, because I have basically three broad topics to talk about.

Mr. MOSS. You may proceed.

Mr. WALLICH. It wasn't stated on the record.

Mr. MOSS. Also in introducing Professor Wallich I wanted to say I believe you were a member of the Council of Economic Advisers to former President Eisenhower.

Mr. WALLICH. That is right, Mr. Chairman.

Mr. MOSS. Thank you.

Mr. WALLICH. Congressman Keith, do you wish to pause at this point?

Mr. MOSS. You proceed with your summary.

Mr. WALLICH. Very good. The upshot from these considerations is the following: The statistical evidence shows that by and large random portfolios, blindly picked portfolios, do as well as expertly picked. There are some exceptions which do not prove or disprove the rule. The overall evidence still stands. The conclusion is that on average and in general investment advisory fees are unjustified, because investment advice is worth zero.

Now that doesn't mean that particular funds haven't done well, haven't done better than the average, or that particular funds haven't done well in particular years. I am speaking of a long-term broad average, the kind of experience that an investor would have if he invested over 20 or 30 years. He would on average be as well off throwing darts as he would be attaching himself to the fortunes of a fund.

If that is true, then clearly the function of the funds is not to provide superior performance. It is simply to provide diversification of risk. That they can do with one man and a secretary. There is no need for an elaborate research staff.

If next I may turn to the subject of the sales load, there are two aspects to be considered. One is the ordinary load of 8.5 if expressed as a load, and 9.3 if expressed as a sales charge, and the front-end load. It is necessary first of all to point out that this is not a competitive industry. It is a monopolistic industry with the Government preventing competition at the retail level.

A salesman cannot come to me and say "My normal charge is 8.5 percent but I will let you have it for 2." He would be acting illegally.

Once this kind of Government regulation enters, the arguments for a free market and for nonregulation fall by the wayside. Once a monopoly has been created, there is a strong case for regulation. In this country we have always regulated natural monopolies. Mutual funds have a Government-created monopoly at the retail level. There is a case for regulating it.

My preference would be to abolish retail price maintenance; that is, eliminate section 22(d). I do not believe that the consequences would be disastrous. I do not believe that this would lead to heavy net sales of funds, and if it did, I think the market could probably absorb them. I suspect that the problem between the captive sales forces and the salesmen of the other funds could be ironed out also.

I do think that at least temporarily it might lead to a lower volume of sales. Here one has to make a value judgment. Mutual funds are a good thing. Even a good thing can be brought at too high a price. We would all agree if the sales charge were 50 or 100 percent, that would be very high. Whether 8.5 is right or 5 is right or 15 can become a matter of difference among reasonable men.

It is said that this proposed regulation would affect the fortunes of the industry. If we went to 5-percent sales load, it is said it would lead to a lot of losses of jobs. I would argue this way. If we raised the charge to 15 percent, we could employ still a lot more people in the industry. We are thus implicitly depriving potential people of a potential job by having the present charge. The fact that some people would lose their job has to be seen in that perspective.

These salespeople are on the whole, one can say, not very well paid. I think \$7,000 is the median average income. This is something that a halfway competent salesman can make in a lot of other lines. It is not at all clear that a great favor is done to these salesmen by keeping them in marginal positions selling funds, unless a strong case can be made that these funds ought to be sold because the buyers ought to have access to funds.

On that question I agree a reasonable case can be made. Mutual funds are a desirable thing to have. They are worth paying for. They are worth paying a substantial sales load. But considering the ways in which people can be sold without the sales charge, I think 8.5 percent is too high.

Today people can be sold through newspapers, they are sold through radio, and there are ways of getting to low-income people by word of mouth. All that suggests that once the ice has been broken—and surely the ice on mutual funds was broken long ago—we can go to a lower charge.

Turning next to the front-end load funds, if I may refer to a personal experience, I started analyzing this issue with the preconception usual among economists that a 50-percent front-end load is a very bad thing. I partly unsold myself on this as I looked at the evidence. It seems clear that front-end load sales go to a different type of buyer, one who otherwise really wouldn't have a chance to buy, and who probably is not a reader of the financial pages of the Times and the Wall Street Journal and similar newspapers. He has no access to funds. He would never buy. He would never get the benefits. Therefore, I think a case can be made for a front-end load.

The present technique I think is perhaps excessively burdensome. There may be ways of improving it. This could be done through refunds, for instance, to people whose contracts lapse. It could be done by lowering the overall commission somewhat, say to 20 percent from 50, and having the underwriter make up to the salesman the risk.

It is clear that the salesman needs something like 50 percent to come to my door and spend an hour with me selling me \$500 worth of mutual funds. He can't afford to spend that time for less. He has got to be paid. He can't wait to be paid either until I have fulfilled the contract. But perhaps this payment to the salesman could be made up from other sources, principally, of course from the principal underwriter.

This leaves me with my last subject, which is speculative activity.

Mr. KEITH. You mean you are not going to get into the question of fiduciary relationship.

Mr. WALLICH. Congressman Keith, this is a difficult one for an economist. I have no legal background, and I think I might be straying out of my area of competence, if I have one.

The problem of speculative activity: In the last few years we have had the appearance of the performance funds. They have unquestionably done better than the average. Even if we look at the variance of the stocks, they may for a given risk have done better. Furthermore, in declines they have not, like some of the stocks they held, gone down very far. For the most part, they have performed pretty well on declines too.

There is, therefore, the question whether the performance funds really are in accordance with the theory I have propounded before, that on average one cannot do better than the averages, allowing for risk, because all that is known has already been discounted by the existing price of the stock.

I would say this. The theory behind the statement that it is difficult to do better than the market is buttressed by a great deal of historical experience. It is buttressed also by some very obvious a priori thinking. If the performance funds defeat—

Mr. KEITH. What kind of thinking did you say?

Mr. WALLICH. A priori, in other words, theoretical reasoning.

Mr. KEITH. It sounds like a legalistic term.

Mr. WALLICH. It is.

Mr. KEITH. I didn't think you had the competency.

Mr. WALLICH. I stand corrected.

Mr. KEITH. What does it mean?

Mr. WALLICH. It means preceding from something prior; that is, in advance of evidence, or reasoning from prior general principles. However, in this particular case the evidence supports the a priori reasoning. And the evidence is heavy. It is not casual, of the kind that the industry has produced. That is what one would call casual evidence.

If one believes the evidence and the theoretical reasoning, one arrives at the conclusion that the performance funds are generating their own successes. That is to say, they influence the market, and that is why they do better. I have not really studied the detailed evidence on this, but two facts may be cited: (1) activity in the market has greatly stepped up since the performance funds made their mass experience; (2) high-priced stocks have begun to jump about in a

manner that they did not use to do. Five percent, 10 percent, 15 percent per day has become commonplace.

There are simple ways of generating one's own success without in the least conspiring. I don't assume that fund managers conspire with each other to bull a certain stock. But, as Chairman Martin of the Federal Reserve has pointed out, there are nevertheless similarities to the pool operations of the 1920's.

One simple way of making a spectacular impact on the market is to place a large order 10 minutes before closing, good for the day. Then the broker knows that he is going to lose that order unless he finds the stock right away. Then watch the stock take off and go. On the quotation sheet it will show X-Y-Z corporation up five points, 10 points, 15 points. The next day there is a great big pile of buy orders on the desk of the manager of a brokerage firm.

The fact that funds very often go back into a stock after recently selling it also suggests that kind of activity. It doesn't suggest a well considered, long-run approach, such as looking at a stock on fundamental grounds and saying "We want it at this price or we don't." People that go in and out quickly are speculative. Operating in great volume, they are likely to influence prices.

These are my comments on speculative activity. I am not against speculation as such. Speculation performs a useful function. When speculation becomes destabilizing, however, it is bad. When speculation takes over and sucks in the public, it becomes dangerous. When smart speculators unload on less smart speculators, a real social problem is posed.

In other areas we do not allow amateurs to compete with professionals. We do not allow a professional fighter to box an amateur because the amateur would be slaughtered. In the stock market we seem to think it is all right to let the professionals loose on the amateurs. One justification for this open approach would be that by and large the professionals do no better than the amateurs. So let them fight it out. But if I believed that professionals can and normally do slaughter amateurs, I would consider this a real problem that would have to be dealt with.

Thank you very much, Mr. Chairman.

Mr. Moss. Thank you, Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman. As I have listened to the earlier portion of your testimony, which I found really quite interesting and in a way reassuring and reasoned so far as the present posture of the industry is concerned, you mentioned that an individual could do just as well if he would sit down with a secretary and spend a little time thinking about it, and at that point I made a notation. Lots of us don't have secretaries. Others don't have the time, and therefore we don't make those judgments, and we want to be reasonably sure, and so we buy a mutual fund because we want this spread, and we want reasonably good management. If we want to be speculative we buy a performance fund.

But at the same time there is an additional factor as to why we don't have that secretary. We have only got \$20 a month, believe it or not. So I was reassured when later on in your statement you justified the front-end load in order to get the small buyer and the seller together.

You talked later on about the loosening up of the regulations on advertising. I believe the law is quite specific with reference to no-load funds. It would seem to me that a very natural development would be one that I suggested yesterday allow advertising by no-loads similar to that used by savings banks to sell their life insurance. They are allowed to spend only fund resources, in this case I guess it would be the management company's resources. The no-load investment companies resources could be used for promotional material of that sort, if you loosened up the legislation as it pertains to no-load funds' advertising. I would like to have your observation on this, and if you care to on the earlier remarks which I made which were an interpretation of what you said.

Mr. WALLICH. I quite agree with your interpretation, Congressman Keith. We buy mutual funds because we don't want to take the risk of buying a single stock, and we don't have the time and the money to study it. Buying mutual funds in principle is a good idea for many investors.

The fellow with the secretary I envisioned to be the mutual fund manager. He should have a secretary and not a research staff of people drawing sometimes tens and perhaps hundreds of thousands of dollars.

Mr. KEITH. I see. Do you think there already is a little of that in these management companies?

Mr. WALLICH. I think that these people by and large work very hard to no avail. These are able and intelligent people. They work very hard. There is no featherbedding in the sense of loafing on the job. But since a thousand other able and intelligent people have already brought their best judgment to bear on the price of a stock, one can pretty well assume that a stock is selling for what the best human judgment thinks it is worth. To have the same job done over again by another group of able and hardworking people is just a waste of time.

If they don't agree with the price that has been produced by the others, they are as likely to be wrong as right in their different appraisal. That is why I think one can buy a stock without analysis, provided one looks at the risk. The price is likely to be right. The risk may not be suitable for the particular buyer.

Now as to easing the limitations on no-load fund advertising, I think no-load funds are the logical answer to my various strictures. There is still the fact that they charge an advisory fee. I think they should be no-load, no-advisory fee beyond operating expenses. The secretary needs to be paid. There is a mailing problem, a safekeeping problem, and so forth. That I believe is something of the order of 0.1 percent of the value of the portfolio on average, and that is really all the expenses that is justified.

If there is to be advertising, again a somewhat higher either advisory fee or a positive load charge would be needed. I think advertising is entirely appropriate for a no-load fund.

One can do one step better. One can go into the market and find one's self a fund that is closed-end as the term is, and is usually selling at a discount. That discount incidentally says what the market place when it is uninfluenced by salesmanship really thinks of the value of professional management. When you leave it to the market to determine what

the management of these great closed-end funds is worth, they say on average it is minus 10 percent, minus 20 percent, something of that order. There are some slight qualifications because unrealized capital gains enter into the situation in these funds, but that is a minor fact.

Well, in sum I very much agree. Whatever can be done to strengthen the position of no-load funds is a step in the right direction.

Mr. KEITH. Would you agree that the brokers are sort of spoiled, and maybe even get a little bit lazy because instead of doing a lot of homework and coming up with issues that are better than the average, inviting the attention of their clients to these issues, that they take advantage of a client who is also a little bit lazy, perhaps doesn't want to do much thinking or research and he is perfectly willing to buy a good mutual fund, and get a good appreciation, rather than buying a particular stock and getting perhaps a better buy for himself and his family?

Mr. WALLICH. Well, sir, when——

Mr. KEITH. And is this healthy?

Mr. WALLICH. When I was in the brokerage business, we worked very hard I thought. My broker friends I still think are hard working people. There's a problem, however, of preference of buyers in favor of mutual funds because if a broker sells a client a listed stock, he makes one percent commission. If he sells him a mutual fund, he gets some cut in a much larger commission, 8.5 percent. He does not get it all. There may be a salesman's share involved. Something may go to the principal underwriter. But the bias is in the direction that you say.

Mr. KEITH. Well, for the very small buyer, the man who runs the gas station, who teaches school or has a limited amount of money with which he can get into the market, even on the installment plan, it would seem to me that front-end loads and the mutual plan salesman serve a useful purpose.

But when a man can afford to buy mutual funds in the amounts of \$5,000 to \$10,000, he is usually brighter than average, more investment conscious than average, and if he doesn't like the way his mutual funds are working, reading in the press about throwing darts at the paper and things of that sort, he can move into individual issues under the present scheme of things very easily. Maybe he is lazy and content with the average appreciation that is coming his way.

Mr. WALLICH. Yes; I think he would be no better off on average going into individual issues than going into funds, except that he would save the advisory fee. If he buys himself a rounded portfolio his chances are that he will do the same as the average for equal risk stocks, and that is just how his fund is likely to do.

I very much agree that a man can acquire this habit of dealing with his stocks. The problem is to break the ice, get him acquainted with the stock exchange, get him to a broker. Once he has bought securities and knows that he can do it on the telephone, he can shop for himself much more cheaply than he can in mutual funds. Moreover he can get diversification even at present by buying closed-end funds and buying them at a good discount.

Mr. KEITH. This may not be your field, but would you say that economies can be achieved by funds becoming internally managed,

and that perhaps legislation should be enacted that would encourage the establishment of internally managed funds as contrasted to those with management companies?

Mr. WALLICH. I think that internal management makes a lot of sense. It is in keeping with the way other businesses are run, and it is likely to make for better terms for the investor, because then the interest of the management is in doing something for the fund rather than doing something for the management company.

Mr. KEITH. Going to the subject of speculation, you mentioned performance funds. We have had considerable discussion here with reference to these funds. Do you have any evidence that in anticipation of declines in the market that they get into a much more liquid position in a hurry?

Mr. WALLICH. I haven't examined this evidence, but I believe it must be so, because the performance funds have not declined much during periods of decline, when some of the stocks that they typically held, like Xerox and IBM were virtually cut in half. So they must have somehow succeeded in getting out. That is a compliment to their ability, but the reason why some stocks went down so much is, of course, in part that selling by funds occurred.

Mr. KEITH. Have you taken any steps, as one who is knowledgeable in this area, to encourage either the exchanges or the mutual fund industry or the Congress other than your appearance here, to study the possible existence of activities that are adverse to the market's and to the buyers' interests, such as the point you just mentioned about waiting to place an order in the last 10 minutes of the day? Are there other techniques where full disclosure would perhaps inhibit and perhaps help the exchange in the regulation of its own operations?

Mr. WALLICH. I have not studied this sufficiently to feel very sure. These are preliminary impressions, and I feel quite hesitant about suggesting that anything should be prohibited. It may be that the placing of heavy orders at the end of the day has already had a damper put on it. But speculation as such is not a bad thing when it does not become destabilizing. I would go slow on controlling speculation. I would hate to think of controls being employed as they are in the commodity markets, with maximum price movements during a day, for instance, or suspension of trading in some particular issue.

These are interferences with the free market that one goes to as a last resort, to combat very great evils. Very often they have side effects, such as creation of black markets, that frustrate the intention.

If I had any suggestion in this area what to look at, without recommending it firmly, it would be to do something via the tax route. For quick in-and-out trading funds would be deprived of the conduit privilege. It is not a very great privilege that they have, of not paying income tax on their dividend receipts if they pay out 90 percent. If you withdrew that privilege, the so-called conduit arrangement, then funds would only pay tax on 15 percent of intracorporate dividends. This would not be a very heavy burden anyway. A tax on their capital gains would be something else.

Another approach that would not directly interfere with the market would be to put some limitation on turnover and impose perhaps

higher taxes if the turnover exceeded a certain percentage of portfolio. I feel quite hesitant about that kind of thing. I would want to know more facts first before coming out flatly for it.

Mr. KEITH. Would you think it advisable that the legislation we are considering have perhaps a title or a section authorizing a study of speculation? Is that important?

Mr. WALLICH. A study would be a good thing. I think it should not interfere with going ahead on the other points. But if the study was simply part of the legislation being passed, then assuming this study is competently done, it would be a useful one.

Mr. KEITH. I have no further questions at this time, Mr. Chairman. I would like perhaps to ask one more later on in the discussion.

Mr. MOSS. Mr. Watkins?

Mr. WATKINS. Mr. Chairman. Mr. Wallich, you stated that you OK mutual funds. You think that mutual funds are proper.

Mr. WALLICH. Yes, sir.

Mr. WATKINS. You say the mutual funds are proper. You approve the method. I note too that you are a professor at Yale University.

Mr. WALLICH. Yes; that is right, sir.

Mr. WATKINS. And that your approval goes so far that you are bringing in three mutual men, men that are employed in mutual funds to decide your investments.

Mr. WALLICH. Yes.

Mr. WATKINS. Now I am not interested, Mr. Wallich, in the big fellow, how he spends his money. He has plenty of advice, attorneys and professors, and a board of directors. I am interested in the small man who has the opportunity to purchase mutual funds.

You made a statement, if I understand you correctly, that 8.5, 9.3, or 5 percent—the way I understood you to say, that you could use any figure and get the balance that you would need from some other place. What do you mean by that? How are you in business if you only have a certain percentage to pay your salesmen and your cost of operation, your management and the various other costs of setting up this enterprise, this business? What other ways can you get it? You have got to operate at a profit.

Mr. WALLICH. In this complex of earnings that a management or advisory company has and the broker has, there are really three sources of earnings. One is the sales load, the second is the advisory fee, the third is the commissions that the broker gets.

To the extent that there is some personal relationship between the advisory group and the broker and the principal underwriter, and very often that is the case, although by no means always, this money in a sense all goes into the same pot, although not legally. That means—

Mr. WATKINS. You say not legally?

Mr. WALLICH. Not legally because the profits of the advisory company go into the corporate income, the profits of the brokerage firm whose partners may be officers and stockholders of the advisory company go to them directly and are taxed to them directly. When I said not legally, I didn't mean illegally, but that there is a different corporate setup.

Mr. WATKINS. How in your opinion do you think that 5 percent is a fair rate? I have heard a lot of testimony here saying, "Do you agree with this?" Many of these firms would have to go out of business. One firm has 240 employees, operating in the State of Pennsylvania, New Jersey, and Delaware that are giving a real service to the small purchaser of their funds, of their stocks that they sell. They say that they cannot operate on 5 percent. Now that is the meat of what I would like to know.

The technical business is being handled by my friend here. I want to get into that position. That is the biggest complaint against this bill, objection to a 5-percent levy by the SEC.

Mr. WALLICH. Yes, sir.

Mr. WATKINS. Will that ruin a business or won't it? With this 5-percent fee, with these other methods that you say they might have—

Mr. WALLICH. There are always marginal businesses, and some businesses may have to shift to some other line and some salesmen may have to start selling something else if we go to a 5-percent charge.

Mr. WATKINS. Do you think that is proper, that we have the right to rule a man's business out? In other words, a business is operating successfully and not imposing any loss to the public. I understand from testimony it is about 2 percent. What right do we have in your opinion, I am asking you, sir, to do a thing like that?

Mr. WALLICH. The right I think derives from the fact that this is a monopoly. We have retail price maintenance. If you were prepared to institute free competition at the retail level, and let these 240 salesmen go out and really compete, that is to say cut—

Mr. WATKINS. Well, they do compete, don't they?

Mr. WALLICH. They do not, sir. I am sorry, sir.

Mr. WATKINS. They compete with other companies. There isn't just one mutual company. Do you know how many mutual companies there are that do this business in the United States?

Mr. WALLICH. With due respect, they engage in rivalry and they may work very hard. I am not accusing these people of—

Mr. WATKINS. Do you know how many there are? Do you know how many firms there are in this business?

Mr. WALLICH. Yes. I don't know the number. I know it goes into the hundreds. This is not relevant to the proper concept of competition. As Professor Samuelson has said once before, there is a kind of monopoly that a small organization, of which there are hundreds, may have under certain conditions.

For instance, a single bank in a small town, or a drugstore where there is no other drugstore within 20 blocks. In the mutual funds field the nature of monopoly is a little different. It is that the law requires the SEC to engage in retail price maintenance. If two salesmen of different funds meet, and they both charge 8.5, none are allowed to cut.

Mr. WATKINS. Let's stop at the 8.5. I want to take exception. You say that it is a monopoly, and you say it is not competitive. I say it is a competitive business, at least I think so. You can perhaps enlighten me, I will have a change of heart perhaps, but I think it is a competitive business for this reason. Will you agree that if John Smith comes to me from one mutual company and he sells me the idea to purchase various stocks through his firm, perhaps he has got a better in, perhaps

he knows a little more, and perhaps he is a better adviser to me as a little fellow who has no knowledge of stocks.

Now along comes another firm that offers me other suggestions. You say that isn't competitive?

Mr. WALLICH. These people don't engage in price competition, Congressman.

Mr. WATKINS. They don't engage in price but they engage in advice. They engage in advice and that becomes competitive. Maybe one fellow's advice is better than the other's.

Mr. WALLICH. But in my judgment the advice of both is equally good and neither is worth anything.

Mr. WATKINS. In other words, I wonder how much advice it is. Somebody can boost on the stock market, too. They can get a rumor going around to buy Smith & Jones, you name the company, it is going to do so and so and the first thing you know the board starts to move, doesn't it?

Mr. WALLICH. If I may, let me try to define the nature of the difference, and why you view this as competitive and I do not. To me competition basically means price competition, not quality competition, although that is an important aspect. If I go and buy a car in an automobile dealer's showroom, I haggle over the price. I go to the next showroom, the dealer quotes me a different price and we haggle again. With these two mutual fund salesmen I can not haggle. That is what I mean by saying they are not competitive. They may be competitive in other ways.

Mr. WATKINS. I still think they are competitive. You haven't convinced me that it isn't. The business is certainly competitive.

Now getting back to this 5 percent, do you think that they can operate on 5 percent and stay in business? That is what I would like to know. I am very interested in a lot of other testimony here on which you have enlightened me so much, but I want to know about this 5 percent. Do you think if this restriction is put on by the Federal Government here, that they can operate on 5 percent?

Mr. WALLICH. I think the great majority can, and a lot of those who think they can't probably can too.

Mr. WATKINS. Do you have any statistics or figures to prove that they can?

Mr. WALLICH. I have a—

Mr. WATKINS. Other than thinking. In other words, do you have facts and figures that you can show me that these people can operate on 5 percent? I would like to have it.

Mr. WALLICH. I have considerable experience with industry statements that say that they would be ruined by—

Mr. WATKINS. I am not interested in experience, I am interested in facts. Do you have the facts? Can you show me a concrete scale that will show me that they can operate on 5 percent?

Mr. WALLICH. I will be very glad to supply you with one which shows that some, and a great many of them, can. There will be some marginal companies that cannot. I do not deny that.

Mr. WATKINS. Why should we put the marginal companies out? If one large company has a greater volume, a bigger amount of business, he can stay in and the little fellow goes. Is that what we are going to do?

Mr. WALLICH. Because we are imposing retail price maintenance on the public, and I think the public has a right to be protected.

Mr. WATKINS. Is the public being hurt? Do you have any evidence to show that the public is being hurt? I haven't seen any of it here.

Mr. WALLICH. Well, the public paying 8.5 percent certainly is worse off than paying 5 percent.

Mr. WATKINS. Well, certainly 8.5 is higher than 5, but I happen to be—it doesn't have anything to do with this and I shouldn't use the time of the committee. I am in the transportation business, the Watkins System, 30 States in this country. I pay my salesman 10 percent. They hold the 10 percent for the entirety if they can, as long as they are with the firm. So why argue about 8.5 or 10 or 6.5? I am talking about 5. This bill here wants to reduce the payment to 5 percent and that will be it, and that is the meat of this thing. I want to know if you can give me any evidence that says that they can operate on 5 percent or that they can't.

Mr. WALLICH. I would first say that the public first deserves protection before the industry deserves protection.

Second, I think that the majority can operate on 5, and those that cannot will be dollarwise certainly a minority, but we can argue over figures and prospects.

Mr. WATKINS. I don't want to argue. I want to become enlightened through testimony, and I ask you to do this for me. Give me proof that they can operate for 5 percent.

Second, I would like to have you explain to me how the little man will be approached, as my good friend mentioned here, the grocery man, the gasoline station man, the truck operator, too. I want someone to talk to me. How is the little fellow going to operate if someone doesn't come around and try to tell him what is good and what is bad, even though he only makes \$7,000 a year. That is better than being on welfare.

Mr. WALLICH. This is a very real point.

Mr. WATKINS. Exactly. That is the point.

Mr. WALLICH. As I said, you can legitimately even consider a 50-percent-front-end load and a 9-percent-contract-sales load payment, provided the buyer follows through. The front-end load fund does reach a different class of investor. I think this class deserves to be reached. I do think that as the ice gets broken—

Mr. WATKINS. I know that we are pressed for time and I sometimes feel sorry for my chairman the way I use the time up, but frankly, let's get to one point and forget this other aspect. Frankly, do you think the SEC has any right to set a rate of 5 percent on these people?

Mr. WALLICH. As long as it administers section 22(d), yes, because that is what we do with all other regulated industries or natural monopolies. We regulate the price.

Mr. WATKINS. I question your monopoly. I say it is competitive.

Mr. MOSS. Will the gentleman yield?

Mr. WATKINS. Yes; I will, Mr. Chairman.

Mr. MOSS. I think the gentleman is overlooking the fact that Professor Wallich is making that there are a variety of types of monopolies. The point here is that there is monopoly of price. That sales-

man A for company A cannot go out and offer the same share at a lesser figure than salesman B from company B. That on price itself, where normally there is some competition, in this industry competition is absent.

I think another point that has not been touched upon, and must be considered as relevant here, is the effect of the giveup or giveaway to the sales organization to encourage it perhaps to push one fund over another, not because it is a superior performer for the public, but perhaps a superior producer for the dealer. These are elements of competition which this committee must consider.

I thank the gentleman for yielding.

Mr. WATKINS. I would like for you to just come down in plain words and let's get down to it. You say you believe in mutual funds but yet you have other ideas that would wreck them.

Mr. WALLICH. I don't think what the Commission proposes would wreck the mutual funds in the least, Congressman. It would possibly reduce their sales and possibly only in the short run.

In the long run, as people realized that they were not paying an exorbitant charge, there might be more interest in them rather than less. But in the short run I would think that there might be a few salesmen that would then sell life insurance or would sell steel or whatever.

Mr. WATKINS. Why should you switch him from life insurance if he is doing something that is good? What right does this Federal Government have to reach in and tell people what they are going to do? Is this a free country or isn't it? Let's get down to principles, not the bill.

Mr. WALLICH. If it is a free country then why aren't they allowed to compete and cut the sales load? If you will let them cut the sales load——

Mr. WATKINS. Can you tell me how they are going to operate on 5 percent and tell me how many companies will be eliminated? Just don't say some. If you are going to make remarks that are going to be influential on every Congressman here who reads your remarks, then I want to see facts. I don't want to see theories.

Mr. MOSS. The Chair is going to state that the gentleman may demand facts, but the statement that has been presented here represents the considered opinion of a qualified witness. It is as valid as the contentions of those who have appeared and repeatedly said that a reduction to 5 percent would destroy, without submitting any meaningful or relevant statistical material to back up their conclusions.

Now to the extent that the gentleman is able to produce relevant material in response to the question of the gentleman from Pennsylvania——

Mr. WATKINS. That is all I want.

Mr. MOSS. The record will be held to receive it. But the Chair does not expect nor would he instruct the witness to produce the impossible.

Mr. WATKINS. Mr. Chairman, I don't consider it impossible. A man who comes in here with theories must have facts. You don't build theories up unless you have some——

Mr. MOSS. With all charity I would say to my colleague that his theory is not backed by fact.

Mr. WALLICH. May I add, Mr. Chairman, that I base my statement on experience, and experience is normally regarded as part of facts. The experience is that when an industry says that it is going to be ruined, that it is well worthwhile to be skeptical and to take a very detailed look at that position.

Mr. WATKINS. Your college up there employs mutual men to handle their funds. And you say what is the end result, zero. I don't think it is zero. I think life is a chance. When people buy stock, you have a chance. If you buy a mutual fund you have a chance, too. But I would appreciate it if you would give me the information. I have had the opportunity to read part of your testimony before the Senate and I shall certainly read it more carefully, but I would like to have the plain facts to tell me how they can operate at 5 percent, and the ones that you know that can operate and the ones that can't.

Mr. WALLICH. I will be glad to. (See letter to Chairman Moss dated October 27, 1967, on p. 603.)

Mr. WATKINS. Thank you.

Mr. MOSS. Mr. Murphy, do you have any questions?

Mr. MURPHY. No questions.

Mr. MOSS. Mr. Keith.

Mr. KEITH. I don't really want to go into further questions. I would like to visit with you about this personally to satisfy myself as to some points that you have made. I would say that it seems clear that if you lower the charge from 8½ percent or 9 percent to 5 percent, you would still have that same retail price maintenance that you are concerned with, and I would say that we then have two problems. We have the smaller buyer, and you say you are not worried about the front-end load so that salesmen can get to the little man. I believe your testimony indicates that.

Mr. WALLICH. Yes.

Mr. KEITH. I would say that the man who can afford to buy with the larger amounts of money, he can make the necessary research to find out what kind of fund, what kind of portfolio he wants and what kind of price he wants to pay, and that the evidence does indicate that there are variations in this downward from 8 or 9 percent to 1.8 percent or 2.8 percent.

Mr. WALLICH. Yes.

Mr. MOSS. Professor Wallich, I want to express my appreciation and the appreciation of my colleagues on the committee for your testimony. I think it is a very thoughtful and thought provoking statement. I will have several questions to be sent to you at a later date, and I would appreciate your responding to them. I want to, again, thank you for appearing and taking time away from the very busy schedule in order to accommodate the committee.

Mr. WALLICH. Thank you very much, Mr. Chairman.

Mr. WATKINS. I, too, Mr. Chairman, would like to join in thanking you.

Mr. WALLICH. Thank you, Congressman.

(The following letter was received by the committee:)

DEPARTMENT OF ECONOMICS,
YALE UNIVERSITY,
New Haven, Conn., October 27, 1967.

Hon. JOHN E. MOSS,

Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, 2125 Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In response to the question stated in your letter of October 18th and in fulfillment of the commitment made to Mr. Watkins during the hearings, I am submitting the following comments and data.

Question 1. The disabilities under which mutual funds labor (pages 8 and 9 of the statement). The first disability cited in the statement is the tendency for cash inflow to be highest when the market is booming, causing funds to buy more securities when the market is high than when it is low. The data cited in the report of the SEC "Public Policy Implications of Investment Company Growth", and pages 287-289 lend support to this contention. The report cites the Wharton study to the effect that "net acquisitions by mutual funds were greatest 'in the first quarter of 1954 when the price rise was gathering momentum, in the fourth quarter when the price rise was at its sharpest, and in the first quarter of 1955 when stock prices were at their sixteen-month peak'". Table VII-6, page 288, shows that in more recent years net acquisition by investment companies were highest in 1961, the year preceding the great break of 1962. The behavior of mutual funds during the third quarter of 1962 and the third quarter of 1966, cited on page 289, also suggests that the funds were heavy sellers following substantial breaks. According to the SEC report, this was due more to the discretionary investment decisions of fund managers than to the pressures of shareholders' redemptions. The concentration of sales following substantial breaks suggests that preceding these breaks, purchases were relatively heavy.

A second disability cited in the testimony is that the larger funds can obtain worthwhile positions only in the stocks of larger companies and tend to put prices up against themselves when the buy aggressively. Three variables are involved here: 1) the size of the fund and the resulting minimum position that it finds worthwhile, 2) the size of the company whose stock is bought, which limits broadly the amount of stock that could be available, and 3) the breadth of the market for the stock, which sometimes may be small even for a large company if the floating supply of stock is small. The net implication is that large funds cannot buy the stocks of very small companies or even of larger companies with a limited floating supply. Since many large companies have done extremely well, this does not necessarily preclude the large funds from making excellent investments. But the most spectacular investment results probably have been achieved by investors "getting in on the ground floor", i.e. buying stock in a small corporation that subsequently enjoyed great growth. This type of investment is difficult for large funds to make.

The third disability refers to the possibility of window dressing. Information to that effect must necessarily rely on hearsay from trade sources. I am prepared to assume that reputable funds seek to avoid operations that could be interpreted in this light. I hope that the testimony presented the "story", which personally I have no reason to question, in a sufficiently qualified form.

Question 2. The testimony qualifies the suggestion to terminate Section 22(d) by proposing the action only if it does not produce "excessively harmful repercussions." I regard retail price maintenance as undesirable in principle, whatever the industry so protected. In the case of mutual funds, I can see no obvious consequence flowing from the ending of 22(d) that could clearly be expected to produce "excessively harmful repercussions". The principal effect, in my view, would be to reduce the income of underwriters, retailers, and salesmen. The sales charge then would apply only to net sales of fund shares, not to gross sales, assuming that all redemptions would cease and be replaced by sales in a free market on the part of fund shareholders.

The industry, however, seems to believe that termination of 22(d) would have severe consequences. I believe that their case is entitled to a close examination. If this examination, as I would expect, fails to validate the industry's claim, the expectation of excessively harmful repercussions could be disregarded and 22(d) should then in my judgment be terminated.

The qualification introduced in the testimony thus amounts to no more than that the industry's contention be studied before action on 22(d) is taken.

Question 3. The testimony suggests, as one of two alternatives of dealing with the front-end load, that the present load be left unchanged but some compensation be made to holders who redeem at a loss. Several possibilities suggest themselves.

(1) Some grace period could be allowed within which a buyer could cancel the entire transaction and get his money back. This might take care of flagrant cases of "overselling" and would protect buyers who discovered early that they had made the wrong decision. The grace period would have to be relatively short, say a month or two. Else buyers who had no reason to regret their decision in principle might nevertheless claim a refund if the market turned against them. This approach does not, however, take care of buyers who lapse or redeem later on. (2) Compensation could be made to all buyers who redeem, or only to those who redeem at a loss. The best procedure would seem to be that compensation to the buyer be limited to the excess of the front-end load over the normal sales load, allowing any loss from stock market movements to be borne by the buyer. (3) Compensation could also be made to buyers who allow their contract to lapse without redeeming. This approach would remove the temptation, inherent in (2) above, to redeem shares after a contract had lapsed, instead of keeping them in the expectation that payments would be resumed at a later date. Administratively, however, this procedure might be very difficult. It would mean that the fund would have to make restitution of part of the load to all buyers who lapsed even temporarily. When they resumed, the original charge would have to be reinstituted. This could happen several times during the life of a contract. It would establish an undesirable motivation on the part of the buyer.

A more detailed study would have to be made to decide among these alternatives. The grace period proposal gives a minimum of protection and should involve no great difficulties. If alternatives (2) and (3) turn out not feasible or not advisable, I would regard the proposal made in the testimony to reduce the front-end load as preferable to the alternative of a grace period.

Question 4. In commenting on measures that might be taken to limit speculative activity of mutual funds, I did not have specifically in mind disclosure requirements for sales. This approach seems a possibility nevertheless. However, simple disclosure of the fact of a sale probably would not suffice, since funds now publish their portfolios quarterly anyway. Requirement to disclose the reasons for sale, on the other hand, probably could be circumvented, since sales can always be claimed to have been made in order to raise money for purchase of other stocks. It would be difficult to prove that a fund selling a block of stock had information not available to the rest of the market, and in most cases the fund probably would not have such information. To give adverse tax treatment to short term gains would resemble, in a sense, the present treatment of short term gains by insiders. While this solution is not within the legislative scope of the Committee, it would deserve consideration by the appropriate Committees if speculative activity of the funds continues to increase.

QUESTIONS BY MR. WATKINS

In the course of my verbal testimony, I promised to supply certain data in response to questions by Representative Watkins. I hope it will be agreeable to you and Mr. Watkins if I make these data a part of this letter. The question raised by Mr. Watkins was how mutual funds could operate under a 5 percent sales charge, and what parts of the industry would and would not be able to operate under such a charge.

A study was prepared in 1966 by Booz, Allen and Hamilton, Inc., for the National Association of Securities Dealers, Inc., entitled "Over the Counter

Markets Study." Table 1, Appendix D, and Exhibit IV (page 13) of that study were employed by the SEC to produce Tables 1 and 2 attached. Table 1 shows the share that firms of different size have in various sources of gross income, including from retailing mutual fund shares. Table 2 shows the projected loss of gross income for the same firms under the Mutual Fund Report Recommendations. Relevant to the present discussion is only the projected loss of income from mutual fund sales resulting from a cut in the sales charge from 9.3 percent to 5 percent, a reduction of 46 percent. Table 2 also shows the projected loss from elimination of give-ups with which my testimony has not been concerned.

Table 2 shows that the heaviest loss of income would occur in the two lowest size groups, firms with less than \$20,000 gross income, and with \$20-35,000 gross income. The "less than \$20,000 group" would lose 25 percent of its income, the \$20-35,000 group would lose 21.4 percent of its income. There are 707 firms in the lower and 232 firms in the higher income group, out of a total of 2,483 firms. For firms above these two size categories, the projected loss ranges from a maximum of 15.9 to a minimum of 0.9 percent of average gross income. Losses of this magnitude are not essentially different from income losses that occur in the course of business fluctuations. In a time when activity in the securities markets has stepped up considerably, the projected loss would for most firms probably represent no more than a slowing in the rate of growth of their income.

The losses in the two lowest categories, of 21.4 and 25.0 percent respectfully, are of a higher order. They nevertheless present a distorted and misleading picture of the true facts. The 707 firms in the "less than \$20,000 group" have an average gross income of \$8,000. Obviously these are securities firms only in a nominal sense. Very probably they are in good part part-time operations of single individuals. It is hard to see how, on \$8,000 gross income, an office could be rented or an office staff kept.

The 232 firms in the \$20-35,000 group have an average income of \$28,000. These too are operations of minimal size. Together, these two groups representing one-third of the total number of firms have 0.5 percent of total gross income. Their share in the total income from retailing of mutual fund shares amounts to 5.8 percent.

It is by no means to be assumed that even a loss of 25 percent of gross income would drive many of these securities firms out of business at a time when other parts of the securities business are expanding rapidly. But in any event, to continue a 9.3 percent sales charge in lieu of a 5 percent charge, means to charge the buyers of mutual funds an added 4.3 percent. This 4.3 percent charge yields an added income of about \$47 million to the 2,483 firms, of which the 939 firms in the two lowest size classes get approximately \$2.8 million. The total income of these 939 firms is only \$12.2 million. In other words, in order to keep firms with a gross income of \$12.2 million in business, which quite possibly might continue in business in any event, fund buyers would pay an additional charge of \$47 million of which these firms get \$2.8 million. The larger part of this charge, approximately \$44 million, accrues to the bigger firms which, as pointed out above, would not feel its loss very heavily. Mutual fund buyers could pension the 939 small firms off at one-quarter of the cost.

The conclusions which in my judgment follow the data are these. 1) There is no evidence that even the smallest firms cannot survive a cut in the sales load from 9.3 to 5 percent, particularly at a time of expanding securities markets, even though some of these firms may have difficulties. 2) The cost of mutual fund buyers of keeping these firms in business, on the unlikely assumption that otherwise they would mostly go out of business, exceeds the total income of these firms by a multiple of about four. It exceeds the loss that these firms would suffer from the drop in the sales charge by a multiple of almost 17. I can see no justification, either social or economic, for such a policy.

I appreciate the opportunity to submit this additional material.

Sincerely yours,

HENRY C. WALLICH.

TABLE 1.—RELATIVE PARTICIPATION OF 2,483 NASD FIRMS IN SOURCES OF GROSS INCOME ACCORDING TO SIZE OF FIRM
[Gross income for size group as percent of all groups]

Size of firm 1 (in thousands)	Number of firms	Total gross income	Percent						All other
			Corporate underwritings	Stock exchange commissions	Reciprocal and give-up commissions	OTC activities in corporate stocks	OTC activities in bonds	Retailing mutual fund shares 2	
Over \$40,000.....	7	21.6	10.3	29.7	12.3	14.6	7.7	10.1	22.0
\$15,000 to \$40,000.....	19	22.1	33.7	21.0	15.0	14.4	23.6	28.6	25.5
\$6,200 to \$15,000.....	36	14.4	17.7	15.0	11.4	10.9	14.8	5.8	15.9
\$3,300 to \$6,200.....	64	12.7	11.9	12.1	13.7	11.9	15.0	7.8	12.1
\$2,500 to \$3,300.....	34	4.4	5.2	4.6	6.5	3.8	4.1	1.8	4.2
\$2,000 to \$2,500.....	41	4.2	4.0	3.6	5.7	6.0	5.4	3.7	3.2
\$1,440 to \$2,000.....	53	4.1	4.0	3.6	3.8	5.0	5.8	3.7	5.1
\$955 to \$1,440.....	74	3.9	3.9	3.3	3.8	7.6	6.9	4.9	4.4
\$535 to \$955.....	137	4.1	3.3	2.2	7.4	8.7	7.0	6.6	3.7
\$225 to \$535.....	261	4.1	3.3	2.2	7.4	8.7	7.0	6.6	3.7
\$200 to \$225.....	40	.4	.2	.2	1.1	.8	.3	1.0	.4
\$185 to \$200.....	37	.3	.2	.1	1.1	.7	.5	1.0	.4
\$170 to \$185.....	39	.3	.2	.1	1.1	.7	.5	1.0	.4
\$150 to \$170.....	47	.3	.1	.1	.7	.9	.4	1.2	.2
\$135 to \$150.....	47	.3	.1	.1	.7	.9	.4	1.2	.2
\$120 to \$135.....	56	.3	.2	.1	.8	.9	.3	1.1	.2
\$105 to \$120.....	70	.3	.2	.1	.8	.9	.3	1.1	.2
\$90 to \$105.....	76	.3	.2	.1	.8	.9	.3	1.1	.2
\$75 to \$90.....	99	.3	.2	.1	.5	.9	.3	1.6	.2
\$60 to \$75.....	116	.3	.1	.1	.3	.8	.4	1.6	.2
\$50 to \$60.....	152	.3	.1	.1	.3	.7	.3	2.3	.1
\$35 to \$50.....	232	.3	.1	.1	.5	.7	.2	3.0	.1
\$20 to \$35.....	707	.2	.1	.1	.3	.5	.2	3.0	.1
Less than \$20.....									
Total, all reporting firms.....	2,483	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

percent as large if income from mutual fund sales of non-NASD firms were included.

1 Size of firm based on 1964 total gross income.
2 It should be noted that NASD firms account for only about 60 percent of all mutual fund retail sales. Therefore, the percentages shown for each of the NASD groups in the table would be only 60 percent as large if income from mutual fund sales of non-NASD firms were included.

3 Less than 0.05%.

TABLE 2.—PROJECTED LOSS OF GROSS INCOME FOR 2,483 FIRMS UNDER MUTUAL FUND REPORT RECOMMENDATIONS
[Dollar amounts in thousands]

Size of firm ¹	Number of firms	Income from reciprocals and give-ups			Income from mutual fund sales			Total projected loss	
		Average gross income	Projected percentage loss ²	Average gross income	Projected average loss ³	Projected percentage loss ³	Projected average loss		
Over \$40,000.....	7	\$68,850	1.0	\$1,515	\$697	1.0	\$1,386	2.0	
\$15,500 to \$40,000.....	19	28,940	1.2	1,582	728	2.8	1,039	4.0	
\$6,200 to \$15,500.....	36	8,935	1.4	1,700	78	0.9	2,03	2.3	
\$3,300 to \$6,200.....	64	4,438	1.9	129	59	1.3	143	3.2	
\$2,500 to \$3,300.....	34	2,879	2.6	55	25	0.9	100	3.5	
\$2,000 to \$2,500.....	41	2,280	2.4	96	44	1.9	99	4.3	
\$1,440 to \$2,000.....	53	1,752	1.6	74	34	1.9	62	3.5	
\$955 to \$1,440.....	74	1,186	3.8	70	32	2.7	77	6.5	
\$535 to \$955.....	137	710	3.0	49	23	3.2	44	6.2	
\$225 to \$535.....	261	348	3.2	26	12	3.4	23	6.6	
\$200 to \$225.....	40	218	3.5	25	12	5.5	20	9.0	
\$185 to \$200.....	37	198	5.7	28	13	6.6	24	12.3	
\$170 to \$185.....	39	175	4.0	16	7	4.0	14	8.0	
\$150 to \$170.....	39	140	2.7	27	12	7.5	16	10.2	
\$135 to \$150.....	47	143	4.2	19	9	6.3	15	10.5	
\$120 to \$135.....	47	126	2.1	27	12	9.5	15	11.6	
\$105 to \$120.....	56	112	4.1	21	10	8.9	15	13.0	
\$90 to \$105.....	70	97	4.6	18	8	8.2	12	12.8	
\$75 to \$90.....	76	82	4.4	19	9	11.0	13	15.9	
\$60 to \$75.....	99	67	3.0	17	8	11.9	10	14.9	
\$50 to \$60.....	116	54	2.0	15	7	13.0	8	15.0	
\$35 to \$50.....	152	44	2.5	16	7	15.9	8	13.4	
\$20 to \$35.....	232	28	3.3	13	6	21.4	7	24.7	
Less than \$20.....	707	8	2.1	5	2	25.0	2	27.1	
Total, all reporting firms.....	2,483	899	1.7	42	19	2.1	34	3.8	

¹ Size of firm based on 1964 total gross income.

² It should be noted that the loss of income from give-ups is offset by the elimination of payments of give-ups to others; this is not taken into account in the table above.

³ Assuming a 46-percent reduction in income from retail mutual fund sales (i.e., sales charges reduced from 9.3 to 5 percent) and also assuming that the underwriter and the retailer will each take the same percentage loss.

⁴ Less than \$500.

Mr. Moss. Our second witness this morning is Judge Henry J. Friendly, of the United States Court of Appeals for the Second Circuit. Prior to his appointment to the bench in 1959, Judge Friendly was for 30 years engaged in private practice of law. He has had a distinguished career as scholar, lawyer, jurist, and author. Judge Friendly has examined the administrative process, with particular emphasis on the regulation of business by the Federal regulatory agencies.

While in private practice, especially during the years he was general counsel to one of the large companies, Judge Friendly had an extensive administrative law practice. As an appellate judge in the circuit which includes a major business and financial center, he has participated in many decisions involving the statutes administered by the Federal regulatory agencies, including the Securities and Exchange Commission. Judge Friendly wrote the opinion in two important cases involving the Investment Company Act of 1940, *Brown, Bullock & Whilhelm vs. Merchison*.

As an author, Judge Friendly has contributed many articles to legal journals on the administrative process and other topics, as well as a much heralded book entitled "The Federal Administrative Agencies, The Need For Better Definition of Standards."

Judge Friendly's breadth of experience makes him particularly qualified to comment upon certain of the matters which are before this subcommittee, and it was for that reason that I invited Judge Friendly to appear here, and I am very pleased, sir, that you were able to respond to the committee. I want to thank you especially in view of the fact that I understand the air transportation broke down this morning and you had to leave at a very early hour from New York in order to reach us.

STATEMENT OF JUDGE HENRY J. FRIENDLY, U.S. COURT OF APPEALS, SECOND CIRCUIT, NEW YORK, N.Y.

Judge FRIENDLY. Thank you, Mr. Chairman, I think I should apologize to the committee for not having been here at 10 o'clock. Perhaps it was my previous experience as general counsel for an airline that gave me more faith in that medium of transportation than proved to be justified this morning.

As the chairman has stated, I have been a judge of the U.S. Court of Appeals for the Second Circuit for some 8 years. We sit in New York City, and because of its position as the country's largest financial and investment center, we have had rather more than our share of proceedings relating to the statutes administered by the SEC, including the Investment Company Act.

I was asked last spring by Senator Sparkman and have been asked by Chairman Moss to express my views as to the feasibility of the proposal in the bills which you have before you, that there be added a new subsection 15(d), which requires that all compensation for services to a registered investment company by an investment adviser or other specified persons shall be reasonable, with that requirement to be enforceable in an action by the Commission or by an interested party.

I should like to make entirely clear that in complying with that request, as I felt bound to do, I am limiting myself to that precise inquiry. While I have read the relevant parts of the report of the SEC that gave rise to this bill, and some of the material that it has provoked, I would not want as a judge to express any opinion whether the reasonableness of the fees of advisers of investment companies is a problem requiring legislation, or if so, whether section 15(d) is the best possible solution.

On the other hand, I am glad to give the subcommittee such help as I can on the limited question whether Congress should hesitate to enact a requirement like section 15(d) for fear that the courts could not administer it properly. I think I can sum up my position by saying that while the courts are not looking for any more business, because we have plenty, and Congress keeps us well occupied with new lines of business, I perceive no reason why the courts could not effectively administer section 15(d) if Congress should decide that it wants us to do so.

The question whether charges or other business practices are reasonable is not a new question for courts at all. Long before the Interstate Commerce Commission, the first Federal regulatory commission, was created in 1887, courts were deciding about overcharges by railroads and other carriers, and in many states they continued to do that as to intra-State rail rates and other utility rates for many years thereafter, until in the first and second decades of this century public service commissions came to be created.

I think it is peculiarly appropriate to recall that work of the courts before a committee whose landmark report preceding enactment of the Securities Exchange Act of 1934 declared in some famous words that also have their application to mutual funds:

The great exchanges of this country, upon which millions of dollars of securities are sold, are effected with a public interest in the same degree as any other great utility.

In addition to that jurisdiction over public utility rates, courts frequently have to pass on questions of business reasonableness when a corporate acquisition or merger is attacked as unfair to one party or the other. Still another instance where courts have to deal with the question of reasonable value comes from the Constitution itself. I refer, of course, to the provisions of the fifth amendment that private property shall not be taken for public use without just compensation. And the problems that we sometimes encounter in fixing a fair price for a large condemnation, particularly where the property is not of the kind that is freely bought and sold, seem to me at least as hard as the task that is here proposed.

Another very well known area where courts pass on the reasonableness of business practices without aid of any previous administrative determination is in suits by the United States or by private plaintiffs relating to acts that are alleged to constitute unreasonable restraints of trade.

Examples like that, and one could give many others, seem to me sufficient to answer the objection that was made by a witness in the Senate hearings when he said that the question that was posed by section 15(d) is not a legal question but an economic question. I don't

dispute that, but a very large part of the work of the courts consists not in evolving new rules of law but in applying well-known and conceded legal standards to the many complexities of life, whether those be determinations of the fair value of property or the reasonableness of a restraint of trade or what constitutes due care in driving an automobile or in navigating a tanker.

Coming closer to the problem at hand, there are many instances in which courts now have to decide, and for a long time have had to decide, what constitutes reasonable compensation for personal services. One instance is their role in passing on the fairness of arrangements between a fiduciary and his beneficiaries, a standard of fairness that might well apply to this very problem but for the effect that has been given to the ratification of management contracts by stockholders or unaffiliated directors.

Another instance is where a contract for personal services cannot be carried out according to its terms, either because it lacked required formalization, or for failure on some other account, and the court then has to step in and determine the fair value of what has been done.

Still another instance is where no price for the service ever was fixed, as often occurs, for example, in relations between lawyer and client. The standards that courts have used in fixing the value of legal work, the nature and extent of the services performed, the cost to the lawyer of performing them, the novelty of the problem, the amount involved, the results achieved, his professional standing, the contingent or uncontingent character of the reward, the customary charge for comparable services, are quite reminiscent of the standards of section 15(d)(2) of the bill that is before you.

A further area, perhaps even closer to that with which you are here concerned, is the work of the courts in fixing fees of attorneys and others in derivative suits, in decedents' estates, and in bankruptcy and reorganization. Such fees can sometimes be very large, often running into six or seven figures, and the criteria that the courts have applied in fixing those fees are quite similar to those that are here proposed.

I should also point out what may be most relevant of all, namely, that the courts already have responsibilities as to the size of the fees of investment advisers. There is a common law liability of directors for waste, and while a plaintiff who seeks to prevail on that score may have to show that the fee is not merely unreasonable but unreasonably unreasonable, a court still has the job of comparing what has been done with what has been received, just as it would have under section 15(d). I might add that the existing situation here affords great possibilities of lack of uniformity, in view of the differences among the States as to just how much a plaintiff has to prove in cases of that sort.

In addition to these tasks arising out of the common law, the Investment Company Act itself imposes various liabilities in the determination of which the reasonableness of fees of investment advisers may have to be considered. Our court held 6 years ago in *Brown against Bullock*, a case which, as the chairman was kind enough to mention, I was privileged to write the opinion for the court sitting en banc, that a Federal claim against directors existed under section 37 of the act for willful conversion, which could be accomplished by the payment of a

grossly excessive fee to an investment adviser, and under section 15 of the act in its existing form, for failure to exercise proper care with respect to the continuance of a contract with an adviser. Then there is section 36 empowering the Commission to bring suit for gross misconduct or gross abuse of trust. When directors are claimed to have violated those sections in the payment of fees, the court is obliged to make some judgment on the size of the fee, although in order to impose liability, it would have to find the fee not merely excessive but perhaps excessively excessive.

One objection that I understand has been made to judicial enforcement of a standard of reasonableness of the charges of investment advisers is the likelihood of their reaching divergent results, with consequent unfairness to advisers in some cases and to investors in others, although as I have said, that possibility exists in a very marked degree under existing law.

It can be said that the need for uniformity is a reason and surely it is an important reason why once an administrative agency has been given power over a particular subject, the courts should require resort to it in the first instance. But the point in answer to that is that the primary-jurisdiction doctrine applies only when there already is jurisdiction in an administrative agency. It does not rest upon a concept of inherent capacity of the courts to deal with the problem, but as a leading scholar has said, upon recognition of the need for orderly and sensible coordination of the work of the agencies and the courts.

Still I would have to agree that if uniformity in standards as to the fees of advisers of investment companies was the controlling consideration, that would be better accomplished by requiring any complaint to be presented to the SEC for action, subject only to the usual limited judicial review.

However, Congress could well decide that the need for uniformity in this area of the fees of investment advisers was less compelling than as to railroad or other utility rates, and that, accordingly, the court should have a larger and the agency a smaller role. Congress has a considerable variety of choices available to it. Exclusive resort to the SEC would lie at one end of the spectrum. Next would come a direction that except perhaps in cases where the lack of merit of the claim was apparent, there should be an initial reference to the SEC for determination by it, even though ultimate decision would rest in the courts. Further along would be the possibility of a report by the agency, which was merely advisory, and which the court was free to disregard, such as the report the SEC commonly makes as to allowances in reorganization proceedings under chapter 10 of the Bankruptcy Act.

And still further along would be a plan like that of the pending bill, where the agency, in addition to having the right to sue on its own, may but need not intervene in private suits, and the decision rests with the courts.

It is for Congress to decide in each case just what mix of administrative and judicial participation is best adapted to the problem at hand. One end of the spectrum gives more in administrative expertise and uniformity; the other more in those qualities of restraint, freedom from supposed bureaucratic rigidity, open mindedness and good sense that judges at least like to believe are attributes of courts.

I think it is rather heartening to see an administrative agency displaying such willingness to leave the decision to others. For my own part I would return the compliment by suggesting an amendment which would provide that in actions under section 15(d), the court either may or must call on the SEC for an advisory report. I would be quite content with the permissive form, since I am confident that at least in the early days of the statute, it would always be used. On the other hand, I would have no objection to a mandatory requirement.

With such reports available, I would suppose that the courts would develop intelligible guidelines within a relatively short time. That result would be aided by the fact that since actions to recover unreasonable fees are equitable in nature, they would be tried to judges and not to juries. Under the rule that prevails in our circuit and in most others, the conclusion of the trial judge would be freely reviewable on appeal, thereby insuring uniformity within each circuit and providing the possibility of ultimate reconciliation in the Supreme Court if, as I do not in fact anticipate, the circuits were to develop serious conflicts.

Since the claim would be Federal in character, actions could always be brought by plaintiffs in Federal courts or removed by defendants to them, regardless of the citizenship of the parties. However, as the bill stands, Federal jurisdiction would not be exclusive, and there would be nothing to prevent suits remaining in State courts, including continuation of the practice whereby identical suits have often been brought in both sets of courts, with the Federal court utilized for its generally more liberal procedures for discovery and the State court for its generally less rigorous investigation of settlements. At present, Federal jurisdiction under the Securities Exchange Act of 1934 is exclusive, whereas under the Securities Act of 1933 and the Investment Company Act, it is concurrent with the courts of the States. Although I am generally no friend of exclusive Federal jurisdiction, I would think Congress might wish to consider whether in this particular instance it might not be well to confine litigation to the Federal courts, as is done, for example, with respect to suits under the antitrust laws. This would be a step in the direction of uniformity, and the very fact that an action under section 15(d) substitutes for what might have been made an exclusive remedy before the Securities and Exchange Commission would be a sufficient justification.

What remains is the claim that section 15(d) would be a litigation breeder. To my mind, it is not a valid objection that a statute may lead to the bringing of lawsuits. What would matter would be if it lead to the bringing of unjustified lawsuits. While some derivative actions are brought simply for harassment, we have become increasingly aware over the years that others serve a useful purpose in policing directors and officers of companies who otherwise would be laws unto themselves. Indeed, we have the very highest authority for that proposition in the Supreme Court's statement in *J. I. Case Company* against *Borak*, dealing with the SEC's proxy rules, where the Court said that "Actions by stockholders provide the necessary supplement to Commission action, in view of the limited resources of time and money available to the Commission," and has analogized this to the role of the private treble damage suit in the enforcement of the antitrust laws.

I think there are a good many safeguards against unjustified suits under section 15(d). First of all, the funds are given a year to bring their houses into what they conceive to be order, and they would be well advised in my view to reduce advisory fees at least to the level that have been marked out by settlements in the suits brought under existing law.

Funds that had not done that, particularly the large ones, would be the prime targets for private action.

Mr. KEITH. Mr. Chairman.

Mr. Moss. Mr. Keith.

Mr. KEITH. I wish that you would go back to the start of that paragraph that you are now reading.

Judge FRIENDLY. About the safeguards?

Mr. KEITH. Yes. Would you read that again?

Judge FRIENDLY. Yes, I will be glad to. Of course, again I don't mean by saying this to say that Congress ought to do one thing or the other. It does seem to me, however, that some fears have been voiced which, while I wouldn't say they were wholly without substance, I think have been considerably exaggerated. What I was saying was that I think that there are a good many safeguards against the bringing of unjustified suits under section 15(d).

Mr. KEITH. I thought I heard you say "It seems to me that would be reasonable for the Congress to enact some legislation that would require them to be more reasonable in their fees, more closely paralleling those of comparable situations in this area." Did I not hear you say something to that effect?

Judge FRIENDLY. No. I would put it rather that I don't think Congress should be deterred from doing it by fear of litigation, if it thinks it is a good idea generally. Now whether the problem calls for action is something I don't want to speak to.

Mr. Moss. Would the gentleman yield?

Mr. KEITH. Yes.

Mr. Moss. I believe the reference to the statement on page 13, I have been following it rather closely, would provide this language which was read by Judge Friendly:

First of all, the funds are given a year to bring their houses into what they conceive to be order—section 28. They would be well advised to reduce advisory fees at least to the level marked out by settlement in the suits brought under existing law. Funds that had not done this—

and at that point the interjection of the question.

Judge FRIENDLY. All I really meant by that remark was that if I were advising one of these funds, I would certainly tell them to get down that low, which isn't of course very low, but I should think a fund that continued to keep its fees above the level that had been marked out by settlements would be asking for a place as a defendant. That doesn't mean necessarily it would lose the case, but I should think it would be signaling itself out as a target.

Mr. KEITH. Judge, I was not following as closely as was the Chairman, and I missed the word "suits" as it pertains to this particular discussion, and I was thinking of suits in connection with the settlement of estates rather than suits in the cases before courts in this isolated area.

Judge FRIENDLY. I see. Well, I was saying I think that funds that had not brought their fees down to that modest extent, especially large ones, could probably expect to be defendants.

While I think suits might also be brought against some of the smaller funds, my guess would be that the plaintiffs would generally be content to let those await the settlement or judgment in the suits against the larger and more vulnerable ones.

Once a half dozen actions had progressed to settlement or judgment, I should think most funds would bring themselves into a position where they would no longer be attractive objects for suit. I put it just that way because the economies of the situation are such that private actions will not be prosecuted unless there is a strong possibility of success. Plaintiff's lawyers will not wish to spend years litigating against well financed defendants unless there are real prospects of financial reward, and I think we can also be confident that the SEC will not bring unjustified actions.

So to summarize, while I am expressing no views on the question whether there is need to regulate fees of advisers, I do believe that regulation of the sort embodied in proposed section 15(d) will not impose on the courts a task which they cannot satisfactorily perform.

I do think that two amendments would be advisable, one allowing the courts to call on the SEC for an advisory report in any case, and another giving the Federal courts exclusive jurisdiction of suits under this section.

Thank you.

Mr. Moss. Thank you, sir. Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman. I am handicapped by the fact that I am not an attorney and am not able to follow all of the legal questions that are involved. But in the settling of these suits, do you feel that management companies settle these because they have concluded that there was a good chance that the decision might go adverse to their interests? Is that a proper question to ask from this bench to that bench?

Judge FRIENDLY. Well, I will give you my opinion. I think the settlements have been so modest that the companies were exceedingly well advised to take them even if the plaintiffs' chances of success were exceedingly small. It seems to me that they were buying a cheap insurance policy.

Mr. KEITH. In other words, the attorney for the one bringing suit must have felt that he didn't have a good enough chance that he should hold out for a court decision.

Judge FRIENDLY. Well, I think, Congressman, one has to look at the practicalities of these suits. They are brought typically by counsel for people having a very small financial stake in the mutual fund. They don't differ in that respect from other derivative suits, and when I say that, I am not casting any aspersions whatever on the attorneys. Quite the contrary, as I have said, I think they have performed a most useful function.

But the fact of the matter is that the suit is really brought for the benefit of the attorney more than it is for that of the plaintiff, and when the settlement gets up to a certain figure, the attorney is likely to feel that good business judgment on his part dictates accepting it,