because a bird in the hand is considerably more valuable than one in the bush, and there is also a law of diminishing returns. A judgment that would be worth $10 or $15 million won't produce two or three times as much fees as a settlement of five, and I think it is just as simple as that. I don't mean the——

Mr. KEITH. I have been amazed at the protestations of these attorneys who have brought these suits. One in particular has bragged about the fact that he got a half million dollars for a certain suit that he won, and there is no thought in his mind but what that was a reasonable fee for him to charge for the few hours of work that he spent before the bench or even the many hours of work.

Judge FRIENDLY. Many I would say.

Mr. KEITH. In the large amount of these decisions do you feel that the judges were of the opinion that management companies were fiduciaries in the Massachusetts legal sense of the word?

Judge FRIENDLY. Well, I get the impression they did, but they ascribed great significance to the stockholder ratification. Also of course they ascribed a great deal of significance to the general level of charges in the industry. It is very hard to say that defendants were doing something outrageous when they were doing what everybody else was doing.

Mr. KEITH. For example, in the case of Dreyfus Management Co., they are still charging one-half of 1 percent fee, and the stockholders of that management company are entitled to a return; I believe the stock is valued at something like $44 million. They have paid that price for it. In the scheme of things today, in the free enterprise economy, many of these management companies feeling that they are the ones who set up the mutual funds as a vehicle for bringing more funds on which they could get additional advisory fees, it seems to me the whole climate historically has favored the creation of mutual funds as a means for getting additional funds over which the management companies could exercise their judgment and receive their just reward, and if we get them into a strictly fiduciary position, the mutual funds will by custom and common law and statutory law too then be bound to bargain for the best and cheapest that they could, and exercise a truly independent judgment.

Judge FRIENDLY. I think the theory of the existing law was that they would do that, but it hasn't worked out that way, for understandable reasons.

Mr. KEITH. I don't think that the theory of existing law is that way. I think that the law developed to govern the conglomerates that grew in order to successfully operate this industry.

Judge FRIENDLY. What I was referring to were all the elaborate provisions about the length of the contract and the need of annual review and votes of the unaffiliated directors. I think those showed an intention by Congress that these matters should really be looked at. My impression is that that hasn't worked out as intended, and that because it hasn't, this proposal has been made.

Mr. KEITH. Our question of course is what is in the best interest in the long run for our constituents and our country, as to whether or not curtailment of the present legal fabric would diminish interest in the establishment of mutual funds which some of us feel contribute greatly to the economy in the way of providing capital, and an oppor-

tunity for investment for the fellow who wants to get in on this good thing, that is the growth of industry and the development or the subsequent improvement in equity.

Judge FRIENDLY. That I think is the substantive question which I think I ought not speak to, but which you have.

Mr. KEITH. Well, we are looking for all the advice that we can get, I would only entertain any further comment that you wanted to make philosophically or economically on the subject. I am rather sorry that you haven't felt free to do that.

Judge FRIENDLY. Well, I would go this far. It seems to me very hard for anyone to say that there is anything wrong in a requirement that fees should be reasonable. In fact, as I understand it, the industry doesn't challenge that at all. What they are fearful of is that courts will in fact produce fees that are unreasonable, unreasonably low, and that they will be subject to a great deal of harassment, and I can perfectly well understand why they feel that way. In my judgment, their fears are exaggerated, but perhaps if I were sitting where they do, I would feel the same way as they do and prefer to have things remain as they are. You will have to decide who is right.

Mr. KEITH. Do you feel that the usual pattern of stockholder protection exists in this industry as in other industries?

Judge FRIENDLY. I don't think it exists in this industry. It might be an interesting philosophical speculation as to how far it really exists in some others, but I don't think it exists in this from what I have seen of it.

Mr. KEITH. Have State courts shed any light on this subject do you know?

Judge FRIENDLY. All of the decisions have, I think, been in State courts, nearly all certainly, and they haven't shed very much light, because they have felt that this matter of stockholder ratification has taken this situation out of the ordinary rule that where a director is on both sides of the situation he must sustain the fairness of the arrangement, and have put it into the area where the plaintiff has to prove waste, which is a much heavier burden.

Mr. KEITH. How would the stockholders in the management companies be protected in this legislation?

Judge FRIENDLY. You mean the companies that have gone public, where the adviser has sold stock to the public?

Mr. KEITH. Yes.

Judge FRIENDLY. Well, I think they are going to have a real problem if it should turn out that the results would be a downward revision of fees. Of course, I am not saying that they would or wouldn't. If they did, undoubtedly those companies would be somewhat less profitable than they now are. On the other hand, these people bought stock in those companies, knowing that these management contracts were of short duration, were subject to revision, or to cancellation, and they also knew that the Congress of the United States was still sitting and could change the law when it saw fit.

Mr. KEITH. If you were a trustee of an estate, the portfolio of which was $10 million, would you feel that a fee of one-half of 1 percent for the management of that portfolio was unreasonable?

Judge FRIENDLY. Well, I certainly would, in view of the existing scale.

Mr. KEITH. You say you would?

Judge FRIENDLY. I would feel it was unreasonable in view of the fact that I could buy it so much cheaper, unless the man had some unique ability.

Mr. KEITH. Well, the particular fund that I have in mind is Dreyfus Fund, and in relation to what has happened to that portfolio contrasted to we will say a bank in a small city charging one-half of 1 percent for a $5 million estate, the portfolio over a period of years seldom would show the return or the appreciation that the Dreyfus Fund shareholders show.

Judge FRIENDLY. That fund has certainly done remarkably, no one can challenge that.

Mr. KEITH. Once in awhile I get this book out to look at, and if you look at Dreyfus Funds, it has gone through the roof. You look at the others with lesser fees oftentimes, and improvements have been most modest by comparison.

Judge FRIENDLY. Yes. One just wonders whether there is any casual relation. I think there are also other funds that have the same fee as the Dreyfus Fund, with supposedly very competent people running them, which haven't shown anything like that appreciation.

Mr. KEITH. Here we are finding people——

Judge FRIENDLY. I think, of course, a court would take that into account, obviously, if their advisory fee came before a court. Surely a court would take that performance into account.

Mr. KEITH. What troubles me philosophically I suppose is in growing up, going to college, taking business law and learning about caveat emptor. A salesman comes around and there it is fully disclosed, and they may have in hand the reports contained in Trust and Estates and it shows the various fees and all these various funds. Take your choice. "We think you ought to buy this one. Sure we get a good cut out of it, but look what we have done over the years. If you want to buy it," and there is a full disclosure, and the man is in a position to spend $10,000 or invest $10,000, therefore he has shown some business judgment in accumulating that money, it would seem to me that in the scheme of things full disclosure having been present, and a meeting of the minds, that he has a right to enter into that contract and that these people have a right to offer those kinds of funds to the public.

Judge FRIENDLY. Well, they certainly have in the past, there is no question about that. The point I suppose is that in addition to this well informed and well heeled investor, we have a great many other small people who don't know anything about it, and as was brought out before, there isn't any really substantial price competition. I can imagine, coming back to your case, the $10 million estate, if I had such confidence in a particular man, and felt so sure that he was going to do well for me, I might consider it entirely reasonable to pay him five or 10 times the going rate. But at least the submission of the Commission is that that isn't what happens here. That these things are taken rather sight unseen.

Now whether the whole matter is important enough to warrant Congress in acting is a very real question.

Mr. KEITH. The fact that so many cases have been brought and

most of them settled, getting into court and then settling would indicate that the law is working reasonably well in its present form?

Judge FRIENDLY. No; I wouldn't draw that conclusion, because I think the courts have laid down such a heavy burden as to discourage the bringing of these suits, the burden of proof on the plaintiff.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Moss. Mr. Murphy?

Mr. MURPHY. No questions.

Mr. Moss. Mr. Watkins?

Mr. WATKINS. Mr. Chairman. Judge, I wonder if you would clarify my conception. I feel as though freedom of contract is a rule under the Federal Constitution. The exception would be the right of Congress to abridge it can be justified only by the existence of special circumstances such as war, depression, a public utility with monoply power, or a fraud, waste, or similar matters.

Now it seems to me that—do you agree with that?

Judge FRIENDLY. Well, I would agree there has to be special circumstances.

Mr. WATKINS. I am certainly in no position to argue with the distinguished gentleman.

Judge FRIENDLY. No; I agree there has to be a special justification for it. Certainly I agree with that.

Mr. WATKINS. It seems to me as though the SEC has put these mutual people in the same category perhaps with the stockyards, in which there were cases—290 U.S. 420——

Judge FRIENDLY. Perhaps the industry would rather be analogized to——

Mr. WATKINS. Do you agree that it seems as though that is what has happened?

Judge FRIENDLY. Yes; I think it might be a more pleasant comparison to say perhaps it has put them in the same place as the insurance companies. That is a little more attractive analogy.

Mr. WATKINS. I feel as though this is an infringement upon the people's rights, and it seems to me that a Big Brother, which is our Federal agency in this case, why should they substitute their judgment for that of an investor? There doesn't seem to be any quarrel in this country about the investors. I haven't received any. Perhaps there is. I have never received any complaint. Do you think it is legal—do you think it is right that the Federal Government should step in as Big Brother and take my place as an investor, if I want to buy the stock? I should be the one to bring the complaint.

Judge FRIENDLY. Well, I think it is legally defensible for the Government to do this, if you gentlemen find that the conditions are such as have led to Government intervention in other areas, commencing with the railroads in 1887. If you find that, in effect, there is no competition, and that because of the nature of the industry, the buyer really is defenseless——

Mr. WATKINS. Your Honor, when you talk about the railroads you are talking about monopoly.

Judge FRIENDLY. What did you say, sir?

Mr. WATKINS. Railroads are governed by the Interstate Commerce Commission.

Judge FRIENDLY. Yes.

Mr. WATKINS. By the Public Utility Commission, whether it is intrastate or interstate. May I ask another question? I don't want to take up too much time. I promised the chairman I wouldn't, and I am in no position to argue with you. Would you answer this, Judge.

The SEC proposes that the courts shall determine reasonableness of mutual fund management fees. Now do you know of any other industry other than those which operate under a Government franchise or a public utility or a monopoly in which courts are directed to determine the reasonableness of fees charged in the industry for the service rendered?

Judge FRIENDLY. Normally, you give that job to the administrative commissions.

Mr. WATKINS. That is what I thought.

Judge FRIENDLY. Subject to review by the courts. Take the insurance companies as an analogy. There certainly is a great deal of competition in all phases of the insurance business. But all their premiums are regulated by State commissions, subject to judicial review. As I said, that would be a perfectly possible thing for Congress to do here, to give this to the SEC, subject to judicial review. I have a feeling the industry would dislike that even more than it dislikes this, but that is a solution.

What I have tried to suggest is that there is no real reason why the task couldn't be given to the courts in the first instance. It seems to me it is probably less painful to the industry than doing it the other way, although I would see no objection to giving the job to the SEC.

Mr. WATKINS. Do you feel as though the States have properly regulated, or do you think they have done a poor job of it? Don't you think it is an infringement again on States rights? I know in the State of Pennsylvania that we have protected the public in every way, but we haven't gone to the point of setting rates. Don't you think this is going to be an infringement of States rights?

Judge FRIENDLY. I wouldn't know whether they have done a poor job or not. I just haven't familiarized myself with it. I doubt if there would be any great outcry from the States if Congress were to broaden the Investment Company Act or any of the other Federal securities laws. My impression in talking to State judges is that this is a job they are very glad to let us handle.

Mr. WATKINS. I think you will get a lot of jobs if this goes through. I have had 12 years experience in the State of Pennsylvania and am very much interested in insurance, in our securities commission. I feel as though we are moving in this way that this is an infringement. Do you think it is or do you not?

Judge FRIENDLY. Well, it is obviously within the power of the Federal Government, because it is limited to companies that are operating in interstate commerce and using the mails, and so forth. It is always a question of judgment for Congress whether it wants to use the power.

Mr. Moss. Will the gentleman yield?

Mr. WATKINS. Yes, in a minute.

Don't you think, Your Honor, that if this bill were passed, that we might just as well close up the State, if they are going to name rates?

We might as well let them do everything, just get out of business and stop spending the money in protecting the public.

Judge FRIENDLY. I would think there were still quite a few fields in the prevention of securities frauds that are open to the States. I wouldn't be worried about that.

Mr. WATKINS. Go ahead. I yield to the chairman.

Mr. MOSS. I point out that the security markets have been regulated for approximately 34 years by the Federal Government. We are not proposing here to embark upon any new or novel path, nor to take away from the States any significant authority.

Mr. WATKINS. We are doing it in my opinion.

Mr. MOSS. Well, the gentleman, of course, is entitled to his opinion, but I suggest that he might be voicing a more convincing opinion if he should support it more conclusively than he has to this point.

Mr. WATKINS. Mr. Chairman, will you yield?

Mr. MOSS. Of course, I will yield to the gentleman.

Mr. WATKINS. I just wanted to get information from the judge. I respect his testimony, even though I didn't have the opportunity to have his full testimony in front of me, but I will be able to read it later in the record.

Mr. MOSS. If the gentleman had informed the Chair or any member of the staff that he did not have the testimony in front of him, it would have been supplied to him immediately.

Mr. WATKINS. Well, I listened very well and I have no argument with his testimony. I will certainly have to review it.

Mr. MOSS. Will the staff see that the gentleman is given a copy of the testimony so that he may have the opportunity of reviewing it.

Mr. WATKINS. Will the chairman be so kind as to see that I get a copy of it so I don't have to wait for the official record?

Mr. MOSS. The Chair thought that the gentleman was getting a copy in advance as all of the members have, and he will certainly reinforce his instructions to the staff.

Mr. WATKINS. Thank you, and I want to thank the witness for answering my questions.

Judge FRIENDLY. I am very pleased to have had the opportunity.

Mr. MOSS. Judge, I want to express my very real appreciation for your appearance here. I know it has been at a considerable personal inconvenience, but it has been most informative to the committee.

Judge FRIENDLY. Thank you.

Mr. MOSS. The committee will now stand adjourned until 10 o'clock on Monday morning next. We regret that we must ask the witnesses to return at that time. The committee will not meet tomorrow or Friday. The committee is now adjourned.

(Whereupon, at 12:15 p.m., the subcommittee adjourned, to reconvene Monday, October 23, 1967, at 10 a.m.)

INVESTMENT COMPANY ACT AMENDMENTS OF 1967

MONDAY, OCTOBER 23, 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 come to order.

This morning the committee resumes its hearings with Mr. James W. Davant, chairman of the board, Association of Stock Exchange Firms.

Would you introduce to the committee the gentlemen who are accompanying you?

STATEMENT OF JAMES W. DAVANT, CHAIRMAN OF THE BOARD, ASSOCIATION OF STOCK EXCHANGE FIRMS; ACCOMPANIED BY LEON T. KENDALL, PRESIDENT; AND WALTER B. LEVERING, CHAIRMAN, LEGISLATION COMMITTEE

Mr. DAVANT. On my right is Mr. Walter Levering, chairman of our legislative committee, and on my left Mr. Leon Kendall, president of our association.

Mr. Moss. Will you gentlemen be seated.

Mr. DAVANT. Mr. Chairman, in compliance with Mr. Painter's formal notice and rules of the House we have filed a preliminary text of the statement with the subcommittee 5 days in advance of our appearance this morning. In the interim my associates and I have condensed and refined the text, and with your permission I would like to proceed with the shorter version at this time.

Mr. Moss. Is it your desire to have the full text of the original version put in the record?

Mr. DAVANT. Yes, sir.

Mr. Moss. Without objection that will be done. You may proceed with the condensed version.

(Mr. Davant's prepared statement follows:)

STATEMENT OF JAMES W. DAVANT, CHAIRMAN OF THE BOARD, ASSOCIATION OF STOCK EXCHANGE FIRMS

Mr. Chairman, I am James W. Davant, Chairman of the Association of Stock Exchange Firms and managing partner of Paine, Webber, Jackson & Curtis. With me today from our Association are Leon T. Kendall, President, and Walter B. Levering, Chairman of our Legislation Committee. We appreciate this opportunity to be heard on HR 9510 and 9511.

The Association of Stock Exchange Firms is a 54 year old organization of member firms of the New York Stock Exchange. Our 510 member organizations offer a complete array of investment services to all classes and sizes of investors—individual and institutional. And they account, according to New York Stock Exchange research estimates, for at least 40% of all mutual fund sales to the investing public.

Many of our member firms are also members of the American, Midwest and other leading securities and commodity exchanges as well as active in over-the-counter markets and investment banking.

We wish to add to the record our thoughts on how the securities industry can best meet its commitment to the consumer-investor, the publicly-owned corporation and the general public. We will suggest specific criteria for a soundly functioning securities business and evaluate the proposals presently before Congress against these standards.

For financial institutions to function in the public interest, they must:

(1) Provide facilities which are adequate to the growing needs and changing requirements of a constantly expanding economy.

(2) Be able to withstand shock and be able to sustain losses.

(3) Attract and retain efficient and competent management.

(4) Contribute to economic growth free of inflation and economic instability.

Applying these principles to the securities and mutual funds industries, they require that such organizations have the resources and capital to:

(A) Provide highly-trained and qualified sales personnel who are properly motivated to serve the public by educating, advising and protecting the investor. Provide "plant and equipment"—offices, and the proper tools for handling a substantial volume of transactions—so that investors in smaller communities as well as big cities may have ready access to financial markets and receive a full range of investment service.

(B) Reinforce consumer-protection by having the sales force supervised by highly-trained compliance specialists as well as by the partners or management-level officers. The investor must be shielded from possible over-selling abuses from which no industry is immune.

(C) Provide quality investment vehicles and professional services aimed at an ever-broadening range of consumer needs. Consumers save in a variety of ways with varying means and objectives. Thus, to encourage maximum savings and investment flows, a diversification of investment media has to be developed—media which have to be constantly supervised, revised and supplemented by new ideas.

It is against the broad background of these consumer-interest criteria that ASEF moves into its evaluation of the proposal before this Committee.

SALES CHARGES

The recommendation for a 5% ceiling on mutual fund sales charges is a seemingly magic figure, requiring no economic justification as to what it will do to or for the investor in mutual funds or the securities industry. In our view, the SEC has offered no meaningful evidence that the consumer-investor has been harmed by present selling charges. On the contrary, the sales charges do not appear to be inconsistent with the incentive required by sales personnel to bring this savings medium and its benefits to potential investors.

The contention that lower price is the most important—and virtually exclusive—measure of the public interest, that something "cheaper" must be "better" is at best half truth and false economy. The investor, no less than any other thoughtful consumer-purchaser, must weigh carefully the relative merits of lower cost against his needs in terms of both product and service.

Looking ahead, the reduction of sales charges to 5% would place obstacles in the way of expanding the ownership of equity instruments to broader groups, and thus, limit rather than enlarge the savings services made available to the public. Fund sales personnel would be discouraged from catering to smaller investors who buy in lower dollar units and to investor outside urban centers. Our smaller regional firms tend to secure a relatively greater share of their revenues from mutual fund sales than larger firms, so the burden would fall particularly hard on them. Mutual fund investors are also being educated continually as to investment securities and the expanding availability of funds having differing investment objectives, and regularly supplied with market information from which they can make their own investment decisions.

In view of the paucity of information and economic justification behind the SEC's proposal, and the considerations noted above, it is our firm conviction that more comprehensive and detailed studies of the subject should precede any legislative action in this area. It is determined that the services of an industry-government study group would be an appropriate vehicle for this effort, the ASEF—as in the past—stands ready to participate.

MANAGEMENT FEES

As ASEF sees it, it is clearly in our customers' and our own best interests to do everything possible, as distributors of mutual funds, to assure the continued maintenance of high standards of service and performance on the part of fund managements. The reservoir of individuals with outstanding managerial talent is never excessive in a growing economy, and such executives must be compensated according to the values they create.

Here, again, there is incomplete documentation. What little analysis there is relates fees only to the cost of producing services—a rerun of the cheaper-must-be-better theme. There is no recognition of the fact that in most service businesses (and particularly in the business of money management), any true measure of fees charged must also consider the *value* of services rendered. In fact, determining the appropriateness of fees and commissions by relating them only to costs, could very quickly destroy the ability of the industry to deliver value to public investors.

The present approach, whereby directors of investment companies and their shareholders, using their best judgment, pass on the reasonableness of management fees, is far superior to the SEC's approach of regulatory and judicial determination. An increase in the ratio of independent directors from 40% to a majority, would be consistent with the public interest. To have these directors make a specific finding regarding any management fee contract may also be in order. Such steps, we feel, would tend to minimize any risk that the public and shareholders' interests may be jeopardized by excessive costs for management.

INDUSTRY RESPONSIBILITY TO ITS CUSTOMERS

The consumer-investor is better protected in the United States than anywhere else in the world. In buying securities, he is afforded three levels of protection: By those in the individual securities firms striving to earn and retain his confidence; by strong self-regulatory agencies; and by federal and state governmental agencies functioning under laws designed to protect the public interest.

The securities industry has been striving diligently to achieve higher standards of professionalism and service through more thorough training of salesmen and the introduction of modern data processing equipment and high-speed communications systems. In cooperation with the SEC, and acting under its self-regulatory authority, the industry also is committed to meticulous compliance with a mounting multiplicity of laws, rules and reporting requirements. These efforts, voluntarily instituted as often within the industry itself as in response to outside pressures, have unquestionably benefited the investing public. Of course, these measures have resulted in higher costs of doing business.

The New York Stock Exchange has taken a formal look ahead, to try to determine the size and scope of the needs of a growing investing public in an expanding American economy over the next decade. This review led to some startling conclusions. By 1975, shares listed on the NYSE alone can exceed 20 billion—double what they are today. The number of potential shareowners is expected to increase by at least 10 million, and shares traded will rise accordingly. The Exchange community alone will have to add 50,000 more persons to its payrolls, including 25,000 more qualified and trained sales representatives. This is eight more people for every ten employed today (and many more than that number will have to be recruited and trained to produce a net addition of 25,000). As many as 1,500 additional offices—four more for every ten now in operation—will have to be planned, located and staffed.

The Exchange research indicated our industry must attract an additional $85 for every $100 of capital now employed in the business. To attract an additional $1 billion in needed capital funds, we will have to maintain a level of profitability sufficient to induce such new capital to flow to it.

The present proposals do not accord sufficient weight to the economic consequences of the recommendations on the ability of the securities industry to meet

its commitments to its present and prospective customers and to a growing national economy. To pare down profit margins, while causing costs of investor services to rise may well change the investment industry in ways that will be adverse to the public interest.

CONCLUSION

On the basis of the criteria set forth in this statement, the key proposals in HR 5910 and 5911, if adopted, would, in our view, result in less rather than more protection and in poorer rather than better service to the investor. The evidence at hand is inadequate for the establishment of guidelines which may well prevail for the next generation and have a serious impact upon an industry as dynamic and important to the national welfare as the mutual fund industry.

We submit that the implementation of these proposals will:

Result in the deterioration of service to the investor. Some firms may discourage mutual fund business. Fewer new and specialized funds will be developed. Motives for innovation will be less compelling and services will be retrenched.

Result in less protection for investors, because it will curtail the industry's financial capacity for raising its standards and introducing new safeguards.

Discourage competent individuals from entering the securities business by reducing compensation and the availability of financial incentives.

Finally, the legislation before this Committee promises to set down legislative guidelines which could be controlling for many years. In our view, the case presented for changes of so fundamental a nature has not been sufficiently documented through essential basic research.

Mr. DAVANT. Thank you, sir.

The Association of Stock Exchange Firms is a 54-year-old organization of member firms of the New York Stock Exchange. Our 510 member organizations offer a complete array of investment services to all classes and sizes of investors—individual and institutional. They account, according to New York Stock Exchange research estimates, for at least 40 percent of all mutual fund sales to the investing public.

Many of our member firms are also members of the American, Midwest, and other leading security and commodity exchanges as well as active in over-the-counter markets and in investment banking.

We wish to add to the record our thoughts on how the securities industry can best meet its commitment to the consumer-investor, the public owned corporation, and the general public. We will suggest specific criteria for a soundly functioning securities business and evaluate the proposals presently before Congress against these standards.

For financial institutions to function in the public interest, they must—

(1) Provide facilities which are adequate to the growing needs and changing requirements of a constantly expanding economy.

(2) Be able to withstand shock and be able to sustain losses.

(3) Attract and retain efficient and competent management.

(4) Contribute to economic growth by attracting savings for investment.

Applying these principles to the securities and mutual fund industries, they require that such organizations have the resources and capital to—

(A) Provide highly trained and qualified sales personnel who are properly motivated to serve the public by educating, advising, and protecting the investor. Provide "plant and equipment"—offices and the proper tools for handling a substantial volume of transactions—so that investors in smaller communities as well as big cities may have

ready access to financial markets and receive a full range of investment service.

(B) Reinforce consumer protection by having the sales force supervised by highly trained compliance specialists as well as by the partners or management-level officers.

(C) Provide investments and financial services to meet consumer needs. Consumers save in a variety of ways with varying means and objectives. Thus, to encourage maximum savings and investment flows, a diversification of investment media has to be developed.

With this as background, let us examine the proposals.

SALES CHARGES

The recommendation for a 5-percent ceiling on mutual fund sales charges is a seemingly magic figure, requiring no economic justification as to what it will do to or for the investor in mutual funds or the securities industry. In our view, the SEC has offered no meaningful evidence that the investor has been harmed by present selling charges. On the contrary, the sales charges do not appear to be inconsistent with the incentive required by sales personnel to bring mutual funds to potential investors.

The contention that lower price is the most important—and virtually exclusive—measure of the public interest, that something "cheaper" must be "better" is at best false economy.

In our view, the reduction of sales charges to 5 percent would place obstacles in the way of expanding the ownership of equities to broader groups, and thus limit rather than enlarge the savings services made available to the public. Fund sales personnel would be discouraged from catering to smaller investors who buy in lower dollar units and to investors outside urban centers. Our smaller regional firms tend to secure a relatively greater share of their revenues from mutual fund sales than do larger firms, so the burden would fall particularly hard on them. Mutual fund investors using ASEF firms are also being exposed continually to other investment opportunities, and are regularly supplied with market information from which they can make their own investment decisions.

In view of the paucity of information and economic justification behind the SEC's proposal, and the considerations noted above, it is our firm conviction that more comprehensive and detailed studies of the subject should precede any legislative action in this area. If it is determined that the services of an industry-government study group would be an appropriate vehicle for this effort, the ASEF—as in the past—stands ready to participate.

MANAGEMENT FEES

As we see it, it is clearly in our customers' and our own best interests to do everything possible, as distributors of mutual funds, to assure the continued maintenance of high standards of service and performance on the part of fund managements. The reservoir of individuals with outstanding managerial talent is never excessive in a growing economy, and such executives must be compensated according to the values they create.

Here, again, there is incomplete documentation. The available analysis relates fees only to the cost of producing services. There is no recognition in the SEC proposal of the fact that in most service businesses (and particularly in the business of money management), any true measure of fees charged must also consider the value of services rendered. In fact, determining the appropriateness of fees and commissions by relating them only to costs, could very quickly destroy the ability of the industry to serve public investors and particularly the smaller investors.

The present approach, whereby directors of investment companies and their shareholders, using their best judgment, pass on the reasonableness of management fees, is far superior to the SEC's approach of regulatory and judicial determination. An increase in the ratio of independent directors from 40 percent to a majority would be consistent with the public interest. To have these directors make a specific finding regarding any management fee contract may also be in order. Such steps, we feel, would tend to minimize any risk that the public and shareholders' interests may be jeopardized by excessive costs for management.

INDUSTRY RESPONSIBILITY TO ITS CUSTOMERS

The investor is better protected in the United States than anywhere else in the world. In buying securities, he is afforded three levels of protection: By those in the individual securities firms striving to earn and retain his confidence; by strong self-regulatory agencies; and by Federal and State governmental agencies functioning under laws designed to protect the public interest.

The securities industry has been striving diligently to achieve higher standards of professionalism and service through more thorough training of salesmen and the introduction of modern data processing equipment and high-speed communications systems. In cooperation with the SEC, and acting under its self-regulatory authority, the industry also is committed to meticulous compliance with a mounting multiplicity of laws, rules and reporting requirements. These efforts, voluntarily instituted as often within the industry itself as in response to outside pressures, have unquestionably benefited the investing public. Of course, these measures have resulted in higher costs of doing business.

The New York Stock Exchange has taken a formal look ahead, to try to determine the size and scope of the needs of a growing investing public in an expanding American economy over the next decade. This review led to some startling conclusions. By 1975, shares listed on the NYSE alone can exceed 20 billion—double what they are today. The number of potential shareowners is expected to increase by at least 10 million, and shares traded will rise accordingly. The exchange community alone will have to add 50,000 more persons to its payrolls, including 25,000 more qualified and trained sales representatives. This is eight more people for every 10 employed today—and many more than that number will have to be recruited and trained to produce a net addition of 25,000. As many as 1,500 additional offices—four for every 10 now in operation—will have to be planned, located, and staffed.

The exchange research indicated our industry must attract an additional $85 for every $100 of capital now employed in the business. To attract an additional $1 billion in needed capital funds, we will have to maintain a level of profitability sufficient to induce such new capital to flow to it.

The present proposals do not accord sufficient weight to the economic consequences of the recommendations on the ability of the securities industry to meet its commitments to its present and prospective customers and to a growing national economy. To pare down profit margins, while causing costs of investor services to rise may well change the investment industry in ways that will be adverse to the public interest.

CONCLUSION

On the basis of the criteria set forth in this statement, the key proposals in H.R. 9510 and 9511, if adopted, would, in our view, result in less rather than more protection and in poorer rather than better service to the investor. The evidence at hand is inadequate for the establishment of guidelines which may well prevail for the next generation and have a serious impact upon an industry as dynamic and important to the national welfare as the mutual fund industry.

In summary, reduction in the profitability of investment firms could well result in:

1. A deterioration of services to the public, many of which are provided without charge;
2. Hampering the industry's ability to compete for qualified personnel and to train and supervise them adequately, in the interest of serving the public to best advantage;
3. Impairing the ability of firms to meet the increasing regulatory requirements designed to protect the investing public;
4. Inhibiting the flow of new capital into the business at a time of accelerating demand for additional investment services;
5. The inevitable consequences of making large firms larger and forcing smaller firms out of the business, thereby limiting the choice investors have in securing investment services.

I thank you, sir.

Mr. Moss. Thank you. Mr. Watkins.

Mr. WATKINS. Thank you, Mr. Chairman.

Mr. Davant, would you consider mutual funds a monopoly, or would you consider it a competitive business.

Mr. DAVANT. I consider it a very competitive business. There is a choice of buying any number of investment media, any number of mutual funds, either no load, load, closed end, open end. This is an area where there is complete disclosure of information. The investor has complete ability to move from one investment to another.

Mr. WATKINS. I thank the gentlemen.

I have no further questions, Mr. Chairman. The statement speaks for itself and I think it is a very fine statement.

Mr. DAVANT. Thank you, sir.

Mr. WATKINS. I appreciate having the opportunity of listening.

Mr. DAVANT. Thank you, sir.

Mr. Moss. Mr. Murphy.

Mr. MURPHY. No questions.

Mr. Moss. Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman.

With reference to management fees, you say on page 3, "The reservoir of individuals with outstanding managerial talent is never excessive in a growing economy, and such executives must be compensated according to the values they create."

The portfolios of these funds in many respects are similar and certainly the research which pays off for one stock of one company considered for the portfolio of one fund pays off to the other funds. They are well compensated for the work that they do.

The evidence that we have seen here would indicate that, particularly when you contrast the success of their portfolios with others. But that is an observation, not a question.

When you go on in the third paragraph on that same page and say, "To have these directors make a specific finding regarding any management fee contract may also be in order."

Don't you argue that they in effect do that now, these particular directors?

Mr. DAVANT. I can't answer in the specific instances. I think it is quite usual in boards for outside directors to perform this function. I think it would be desirable to have them do so.

Mr. KEITH. Actually, it seems to me what it does is invite attention to the fact that these unaffiliated directors have to stand up for the fund shareholders.

Mr. Chairman, I have some questions that are not specifically for this witness. It is my understanding that we may ask these questions of any witness by correspondence and that the time will not expire today.

Mr. Moss. That is correct. You have 2 weeks following the close of these hearings to direct written inquiries to any of the witnesses who have appeared before us.

Mr. KEITH. And then they would have 2 weeks in which to respond.

Mr. Moss. A maximum of 2 weeks.

Mr. KEITH. I would be perfectly satisfied if you gave us less so as to shorten the total span. If you wanted to, the period might be 5 days for committee members to ask questions and 2 weeks for response.

Mr. Moss. Is there unanimous consent?

Mr. WATKINS. No, I object to that. I don't see any reason for rushing this.

Mr. Moss. Counsel advises me that the record shows that the original unanimous-consent request was the period of time would be a total of 2 weeks after the witness made his appearance, so that will accommodate the gentleman from Massachusetts.

Mr. KEITH. In other words, if I expect them to do an adequate job I should get my questions in fairly soon.

Mr. Moss. Yes.

Mr. KEITH. I have no further questions, Mr. Chairman.

Mr. Moss. Mr. Davant, I note that in reference to the mutual fund industry you state the management sales role and management fee should be retained in order to have a sound functioning and profitable securities business. It is my recollection that several years ago the

rule of thumb was that the securities business was profitable with 2 million shares on the New York Stock Exchange and that that figure was set more recently at somewhere around 3 million shares a day with the concurrent trading of the American Stock Exchange.

Now, we have been witnessing trading days of up to 10 million shares a day. What is it that is unsound about the securities industry in view of this volume already achieved?

Mr. DAVANT. The volume, sir, has a way of coming and going, particularly in this business. Our break-even point now is a good deal higher than the 3 million shares per day. In 1965, it was 4.8 million. The most recent break-even point I have seen is approximately 7 million shares per day.

Mr. Moss. Would you supply the committee with that data and the source of it.

(The following information was received by the committee:)

BREAK-EVEN POINTS ON SECURITY COMMISSION BUSINESS—1961–1966

According to reports prepared by the New York Stock Exchange on the income and expenses of member organizations, the break-even points on security commission business between 1961 and 1966 are as follows:

Year	Break-even point (shares)	Average daily NYSE reported volume (shares)
1961	3,100,000	4,100,000
1962	3,700,000	3,800,000
1963	3,900,000	4,600,000
1964	4,100,000	4,900,000
1965	4,800,000	6,200,000
1966	5,900,000	7,538,000

During 1967, the break-even point has risen further, to approximately the 7 million share level and perhaps above that level. The staff members of the Exchange responsible for assembling and analyzing these data have corroborated my judgment here.

The Exchange defines the break-even point as the minimum average daily NYSE reported volume needed by member organizations doing business with the public to cover expenses on their security commission business. Among the special factors at work recently tending to push the break-even point higher have been the increased costs of plant and equipment—especially data processing machinery, the cost of overtime to handle present workloads, the recruiting, breaking-in and training of new and lesser skilled employees, the second shift operations to handle volume, and the special costs generated by the log jam of paperwork that has hampered efficient operations in many back-offices.

Mr. DAVANT. Yes, sir.

Mr. Moss. Is that on the stock exchange alone?

Mr. KENDALL. Sir, these data are from the New York Stock Exchange 1967 Fact Book. They report here the figures through 1965, based on the New York Stock Exchange Income and Expense Report, which is an official report made by member organizations to the exchange.

The 1966 figure should now be available. I do not have it here, but we would be pleased to make it available to you.

Mr. DAVANT. Mr. Chairman, the cost of doing business has risen substantially in this business as I suppose in most businesses. For instance, when I started some 22 years ago, I was told to go out and sell. Here is a book. We now train our sales representatives over a pe-

riod of 6 to 8 months, speaking from my own firm's experience, and we estimate our cost at about $15,000 per man, before he is permitted to deal with the public.

Mr. Moss. But you have reached about the 2 billion point trading volume this year, with the average of course at 10 million a day, which appears to still be a relatively profitable area. As I recall a recent study indicates that the commissions paid last year were in excess of 1.4 billion, or about one-half of 1 percent of the gross national product, which suggests a rather significant volume of income from the exchanges. Is that correct? Are you having difficulty hearing?

Mr. DAVANT. Yes, sir; I am.

Mr. Moss. That is a most unusual experience for me to have people who have difficulty hearing me.

Mr. DAVANT. I am sorry, sir. Now I can hear you.

Mr. KENDALL. Sir, if I may, I think truthfully what has happened to us is that in the last 2 to 2½ years the volume of activity on exchanges had doubled. In order to accommodate to this, we have had an increase in overtime, an increase in costs of operations that have been of an almost, I don't want to use the word, "crash"——

Mr. Moss. Isn't that precisely what it is? You have had an unanticipated growth.

Mr. KENDALL. That is right, sir.

Mr. Moss. And it has been riding for some time at a very large level which was also unanticipated.

Mr. KENDALL. That is correct.

Mr. Moss. And as a result you have found yourself faced (1) with a lack of trained personnel, (2) with a lack of automation sufficient to handle the volume, and (3) you have been required to engage in the uneconomic practice of excessive use of overtime.

Mr. KENDALL. Correct.

Mr. Moss. You tend to shy away from overtime. You reach a point where physical resources don't match perhaps the appetite for dollars.

Mr. KENDALL. That is correct, sir, and for example, to go further on this point, as the new president of the association, the first assignment the board gave me was to add to our staff a director of personnel development who has the specific assignment of attracting, recruiting into Wall Street and training up to 10,000 new employees for the operations area, not the sales area but the operations area, within the next 6 to 9 months.

Mr. Moss. That gets me on to my next question. On page 4 of the revised statement you discuss the growth and the need for a greatly expanded sales force, projecting I think through the year 1975. But if the present trend for institutional buying or institutionalization continues, does it follow that there will be the same requirement for increased sales representatives by members of the exchange to sell issues on the exchange?

Isn't it more likely that the recruiting problem will be to recruit the sales force to sell mutual funds rather than the exchange shares themselves?

Mr. DAVANT. Mr. Chairman, I speak in reference again to my own firm. Approximately 6 percent of our income is derived from the sale

of mutual funds. This is part of our business, but in effect we are a department store of investing, and a mutual fund is not the answer for all investors. We must provide services throughout the country for investors to make their own choices as to which types of investments they would like to make.

Mr. Moss. Let's reverse it and put it the other way. Is the anticipated growth in individual investor participation exepected to keep pace with the institutionalization of the market.

Mr. DAVANT. Yes, sir.

Mr. Moss. Do you have any studies to back up that statement?

Mr. KENDALL. Sir, I was the author, the project director is a more appropriate term, of a study looking into 1975 for the exchange community. This was done in 1965. At that time, based on information and studies by the National Industrial Conference Board, a fine research organization in New York, we determined that the number of Americans earning $10,000 or more a year would likely double between that year and 1975. These households have a potential of discretionary purchasing power which makes them possible investors for the first time.

We also know that it is not unusual for a mutual fund shareholder to also own common stocks. The Investment Co. Institute Fact Book, which I have before me now, indicates that the composite shareowner owns 2.7 common stocks directly and 1.4 mutual funds.

Mr. Moss. Mr. Kendall, my question went to the nature of the study and the availability of it for this committee, the study, at least the conclusion that the growth of individual buyers of shares will keep pace with the growth of the institutionalization of the market as a result of the growth of the number of mutual funds and mutual fund shares.

Mr. KENDALL. I would say that the potentials that we see in the evolution of the American household are such that if these potentials are developed by sales techniques, by branch networks, by services amenable to them, that, yes, sir, this would continue.

Mr. Moss. That isn't what I asked. I said is there a study? You indicated that you were the author of a study.

Mr. KENDALL. Yes, sir.

Mr. Moss. I asked if that study is available to this committee.

Mr. KENDALL. I can make this study available to the committee quite readily, sir.

Mr. Moss. All right. Then we ask that the study be made available so that we can have the opportunity to more reflectively consider it.

Mr. DAVANT. Mr. Chairman, may I point out the study is dated December 1965.

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

Mr. Moss. It represents a judgment.

Mr. DAVANT. Yes, sir.

Mr. Moss. Which is being utilized here today as the basis for testimony. Therefore, it becomes very relevant to the inquiry of the subcommittee.

Mr. LEVERING. And relevant too, sir, to the possible thought that additional studies of this type ought to be made available to your committee.

Mr. Moss. We are interested in receiving all the studies we can get. Just in passing here, the question of monopoly. Would you say that the mutual fund industry has all the characteristics of a completely free and competitive product?

Mr. DAVANT. My own firm, for instance, sells variously 123 different funds. The freedom of choice is quite wide.

Mr. Moss. I am not talking of freedom of choice. I am talking of the characteristics of a fully competitive product. Can you cut the price?

Mr. DAVANT. No, sir.

Mr. Moss. You cannot. And then when we get into the management, how much competition is there in this field of management? How many instances in your experience have you known one group of managers to outbid or underbid another group of managers in taking account of that? This is characteristic of a large part of American industry. I think in the advertising industry it isn't at all unusual to see sudden changes in accounts, but here in the mutual fund industry do you have any experience, any significant factor of competition between management groups seeking to garner accounts from each other?

Mr. DAVANT. I have none.

Mr. Moss. And then you also agree that there is price maintenance. There is not competition in price on item A. There might be on item B or C which you can offer, but when you offer them, you offer them at the same price as all of your competition does.

Mr. DAVANT. Yes, sir; like any other fair-traded item.

Mr. Moss. Well is it like a fair-traded item? Can you cite for me a fair-traded item anywhere else that is as universally fair traded, as completely or as uniformly traded as a share in a mutual fund? This is all 50 States as I recall that you have this fair traded.

Mr. LEVERING. Sir, that is a question that would be very difficult for us to answer, but to get back to your——

Mr. Moss. Don't you sell retail?

Mr. LEVERING. Yes, but I am talking about other areas, not the securities business.

Mr. Moss. I didn't raise the questions——

Mr. LEVERING. I couldn't answer it in other areas.

Mr. Moss. I didn't ask you to answer. Mr. Davant is the one who objected to the question and said "Like any other fair-traded item." Those are his words, not mine. Therefore, I just assumed that he had reasonable acquaintanceship with fair-traded items. Now if he hasn't——

Mr. DAVANT. I cannot answer that for other States, sir.

Mr. Moss. You don't really know whether it has the characteristics of other fair-traded items.

Mr. DAVANT. I think that is correct.

Mr. Moss. Thank you. Are there any further questions.

Mr. KEITH. I have one that I would like to get some comments on as to the wide experience of the chairman of the board of the Association of Stock Exchange Firms. That has to do with speculate. Since these hearings started there has been a lot of comment in the press about developing a need for some way to keep track of the buying and selling which might be of a speculative nature, particularly by selling

in a narrow market that might cause a price movement. The fact that a large volume may be disposed of at the end of the day or bought at the end of the day. I would like to know if you think there are sufficient devices available to keep track of this large volume transactions, if there is sufficient exposure to the public of these transactions, and if there is a need for any further light to be shed on them through, perhaps, regulatory path that might be followed but which hasn't yet been taken advantage of.

Mr. DAVANT. Mr. Keith, I believe that the SEC and the regulatory bodies have sufficient authority to carry this out. There is always a problem of speculative excesses. Speculation itself isn't bad, provided it is knowledgeable, and conducted under proper regulation. There has been a substantial amount of activity that has appeared to be speculative in nature recently. I think the stock exchange itself is doing a very fine job of monitoring it. It doesn't do a job that is 100-percent effective because things do slip by, but I think it is doing a very excellent job of monitoring this type of activity.

Mr. KEITH. Do you read Sylvia Porter?

Mr. DAVANT. Sometimes.

Mr. KEITH. She had a very wide readership.

Mr. DAVANT. Yes, sir.

Mr. KEITH. I think very recently she had a column dealing with this, and pointed out that there were a lot of goings-on that were not wholesome in their effect upon the market. But you do not concur, I gather.

Mr. DAVANT. I think the market must constantly be kept under surveillance. In times of great activity there is always the possibility of excesses.

Mr. KEITH. I have no further questions.

Mr. MOSS. Are there any further questions? If not I want to thank you gentlemen for your appearance. Thank you.

Mr. DAVANT. Mr. Chairman and gentlemen, thank you very much, sir.

Mr. MOSS. The next witness is Mr. Richard W. Jennings, professor of law, University of California at Berkeley. Mr. Jennings.

STATEMENT OF RICHARD W. JENNINGS, PROFESSOR OF LAW, UNIVERSITY OF CALIFORNIA, BERKELEY

Mr. JENNINGS. Mr. Chairman and members of the committee, I am appearing here today at the invitation of the chairman of the subcommittee to express my views on H.R. 9510 and H.R. 9511, the legislation of public concern falling in the field of my professional competence.

I have been professor of law at the University of California School of Law, Berkeley, for 20 years, specializing in corporation and securities regulation. Before that I was an attorney engaged in private practice in San Francisco.

I wish to make clear that I speak in an individual capacity and not in my official capacity as a member of the law faculty of my university.

I have prepared and have submitted a statement regarding several items in the proposed legislation. This is not a long statement. I wonder

whether it is the wish of the committee that I read the statement or whether I should just file it and present myself for possible questions?

Mr. Moss. I leave that entirely to your choice, whichever means you feel will most effectively indicate the views you have.

Mr. JENNINGS. I would like to then take up the matter of management fees.

I have restricted myself mainly here to legal problems involved in connection with the mutual fund structure. I will first deal with the problem of the proposed amendments to section 15 of the act relating to management fees.

The mutual fund structure is quite unique in that unlike most American corporations and financial institutions which employ their own staff to manage their affairs, the mutual fund typically receives its investment advice and management services from a separate organization which is owned and controlled by the sponsors of the fund or their successors. The fund usually has a board of directors who negotiate the advisory contract with the investment adviser. Traditionally, the fee in an investment advisory contract was one-half of 1 percent of the average assets of the fund during the year. In the early years of a fund, such a fee may in fact be inadequate. As the fund grows, however, the fee becomes more and more attractive. For example, if a fund has average assets of $100 million at one-half of 1 percent, the fee would amount to $500,000. If the average assets grow to $600 million, the fee computed at the same rate rises to $3 million. And if the fund climbs to a billion dollars of assets, the fee of $5 million becomes enormous. It may be an oversimplification to say that "it costs no more in research effort to buy 100 shares of stock than 100 shares", as Judge Moore suggested in *Brown* v. *Bullock*, 294 Fed. 2d 415 (2d Cir. 1961), but surely this is an area where the economies of scale clearly would be expected to operate.

The Investment Company Act recognizes the inherent conflict of interest between the investment adviser and the fund by requiring (a) that at least 40 percent of the board of directors be "independent" of the adviser, that is not affiliated with it; and (b) that these unaffiliated directors annually approve the contract. Thus, the act supports the illusion that the unaffiliated directors will negotiate the advisory contract on behalf of the fund shareholders. It is also customary to have the advisory contract ratified or approved by a majority of the shareholders. In reality, however, when the shareholders are asked to ratify the contract, they cannot negotiate for the fund. They are limited to rejecting or accepting the contract formulated by the fund directors. Furthermore, with the proxy machinery supposedly in the hands of management, there is no difficulty in obtaining shareholder approval of the advisory contract.

Mr. KEITH. I have a question. You changed your testimony and I wonder the reason for it. You said on page 2 with reference to *Brown* v. *Bullock* "Surely this is an area where the economies of scale clearly operate."

I think you changed that in your oral statement.

Mr. JENNINGS. What I really mean is that it should be cheaper proportionately to operate a $1 billion fund than a $100 million fund. Whether the economies of scale are passed on is another question.

Mr. KEITH. You indicate that they clearly operate with this method.

Mr. JENNINGS. Yes.

Mr. KEITH. One wonders if they really do pass on the economies of scale.

Mr. JENNINGS. I think the economies of scale are there. The question is whether they are passed on to the fund shareholders.

Mr. KEITH. That is the intent that I thought you had, but it didn't read that way. Then you have just changed your testimony on three further: "With the proxy machinery in the hands of management, there is no difficulty in obtaining shareholder approval." You put in the word "supposedly," I believe in there some place.

Mr. JENNINGS. I wonder if that could be read back.

Mr. KEITH. The word "supposedly" could be read back.

Mr. JENNINGS. At what point, sir?

Mr. KEITH. I will reread that sentence.

Mr. JENNINGS. "Furthermore, with the proxy machinery in the hands of management, there is no difficulty in obtaining shareholder approval of the advisory contracts."

Mr. KEITH. I thought you said the word "supposedly" in your oral testimony.

Mr. JENNINGS. I don't recall at what point, sir.

Mr. KEITH. That is all right. I won't belabor it. The record will show it.

Mr. JENNINGS. I think I may well have said—did I say "With the proxy machinery supposedly in the hands of management"; was that the point?

Mr. KEITH. It is my recollection that you said words to that effect.

Mr. JENNINGS. Well, I think, as a matter of fact, clearly the proxy machinery is in the hands of management since they solicit the proxies, so I will ask that the record be corrected to strike out the word "supposedly", which I did add.

May I then continue?

Mr. Moss. Yes.

Mr. JENNINGS. How are the so-called independent directors selected? Again to quote Judge Moore in *Brown* v. *Bullock*, "they are usually selected by and known to management; they are not self-appointed strangers." Indeed, they are invariably so selected. There is, of course, nothing illegal about this practice, but the reality is that while the present Investment Company Act assumes an "independence" on the part of the unaffiliated directors, it is difficult, if not impossible, for the unaffiliated directors to represent and negotiate for the fund shareholders. Indeed, within the mutual fund industry, the view is widely held that the mutual fund corporation is merely a shell, and that the advisory contract is actually negotiated between the investment adviser and the fund shareholders when the fund shares are purchased. Under the shell theory it is argued that the Investment Company Act "recognizes and permits the organization of the externally managed fund, and * * * the stock has been sold to the public on that basis." It is contended, therefore, that the fairness of the advisers fee is not a question for the directors. As a leading attorney specializing in the field has put it: "That is the way it was sold, and even assuming that with a $1 billion or $2 billion fund you could get a cheaper internal organiza-

tion, that isn't what the stockholders bought, and I don't see that there is any requirement on the directors to consider changing the setup." Mr. Alfred Jaretzki, Jr., University of Pennsylvania Law School Conference on Mutual Funds (115 U. Pa. L. Rev. 699, 747 (1967)).

It should be added, however, that since 1959, partly as a result of litigation involving over 20 of the Nation's largest and best known funds, the fees of a number of funds have been scaled down as the assets have grown in size. There are also indications that the unaffiliated directors of some funds periodically review the advisory contract and renegotiate the contract so as to reduce the management fee to reflect economies of scale, the quality of performance, and the like. See Statement of Mr. Robert M. Loeffler, Conference on Mutual Funds (115 U. Pa. L. Rev. 659, 736–37 (1966)).

Despite these exceptions, however, the facts are that the funds have had an enormous growth in the last few years; that management fees rose to staggering proportions; and that in many instances the economies that go with size have not been passed on to the fund shareholders.

It was inevitable that the enormous profits from management fees would make the advisory companies literally gold mines. Accordingly, there have been numerous sales of controlling stock interests in investment advisers, in which the sellers cashed in their chips at an enormous profit and at capital gain rates. A number of advisory companies have made a public offering of the common stock so that the company has become publicly owned. In one case, the selling shareholders reaped a harvest of over $40 million, after deducting underwriting costs, still retaining an interest of about 12 percent, in the management company.

I might say, parenthetically, that you have the curious feature of a fund having an advisory contract with an adviser organization which in a sense has control of the fund, and then which itself goes public, so that public shareholders invest in the adviser, rather than having internalization, and it really is a most curious type of financial structure.

Although the Investment Company Act as originally enacted attempted to cope with the problem, with the enormous growth of funds, the act provided a built-in protection to the fee contract, rather than furnishing a corrective. Section 36 authorizes the SEC to bring an action to remove any director, or investment adviser or underwriter, for "gross misconduct or gross abuse of trust in respect of any registered investment company." In *Brouk* v. *Managed Funds, Inc.*, 286 F. 2d 901 (8th Cir. 1961), the court questioned whether by virtue of section 36 a private right of action existed which could be enforced by shareholders, either derivatively, or by a class action, to recover excessive fees paid. See, however, *Brown* v. *Bullock*, 294 F. 2d 415 (2d Cir. 1961), where the court indicated the possibility of an action under the Investment Company Act.

If a private right of action exists, section 44 vests concurrent jurisdiction in the State and Federal courts. The question is open as to what standard the court would apply in determining the propriety of the fees charged.

Under State law, the courts have been inclined to accept the fund-management company format and refuse to intervene unless the fees

are regarded as unconscionable or shockingly excessive. Thus, in the leading case of *Saxe* v. *Brady*, 184 A. 2d 602 (Del. Ch. 1962), the Delaware Chancery Court held that, even assuming that an independent board did not in fact exist, when the shareholders approved the contract, the management company is relieved of the normal burden of a fiduciary to establish the fairness of the contract; the burden then falls upon the shareholder-plaintiffs "to convince the court that no person of ordinary sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value given" (p. 610). In that case the adviser's fee was the flat one-half of 1 percent rate. Defendants showed that almost 60 percent of the funds in 1961 were charging that rate while almost 30 percent were even higher. Plaintiffs then claimed that the dollar amounts paid under the arrangement were excessive. While some other comparable funds with a sliding scale schedule paid lower fees, the court felt that this did not establish an outer limit. Nor was the sharp rise in profits as a result of an enormous growth in the fund determinative. As the court put it: "[T]he very nature of the compensation arrangement (percentage of asset value) lends itself to the payment of sums having no necessarily reasonable relationship to the 'value' of such services if tested by compensation standards usually applied in the business community." The court stated, however, that under the flat fee arrangement "at some point the relationship between admittedly reasonable expenses and net profit can become so disproportionate as to be shocking by any pertinent standard." The court felt, however, that a fee of $3 million to administer a fund of $600 million did not indicate waste, in view of the practice in the industry. As the court put it, "if the fund-management company format is to be legally questioned, such inquiry must come from some other place."

It would appear that the court felt that that inquiry should be made at the congressional level, because the mutual fund structure as provided in the Investment Company Act really fosters this kind of a result at the judicial level.

Without in any way questioning the quality of the performances of investment advisers, it is believed that any fair appraisal shows that a serious situation of conflict of interest exists that needs legislative correction. See also *Alleghany Corp.* v. *Kirby* 333 Fed. 327 (2d Cir. 1964).

What does the bill propose to correct the situation:

A. The definition of a person affiliated with the investment adviser is sharpened so as to exclude persons having strong ties with the adviser.

B. It repudiates the shell theory by imposing upon the unaffiliated directors the duty to request information and evaluate the reasonableness of the advisory fee; and imposes upon the investment adviser the correlative duty to furnish the information reasonably necessary for the directors to determine the reasonableness of the fee.

C. It supplants the standard permitting excessive fees unless they are regarded by a court to be shocking or unconscionable with a standard that the fees be reasonable. Some of the factors to be weighed in determining the reasonableness of advisers fees are: (*a*) the nature and extent of the services, including separate evaluations of advisory services and other services; (*b*) the quality of the service; and (*c*) the extent to which the fee schedule takes account of economies of scale.

Various safeguards are provided: (*a*) Funds are given 1 year to review their contracts and, if necessary, put their houses in order; (*b*) the burden of proof that the advisers fee is unreasonable is upon the person attacking the fee; (*c*) liability for damages is restricted to those persons receiving the compensation; and their liability is limited to any excess received beyond a reasonable fee as found by a court; (*d*) there is no recovery for compensation paid more than 2 years before the dates on which an action is filed.

The SEC's finding that the management and advisory costs of the externally managed funds are, as a general rule, appreciably higher than the corresponding costs of internally managed funds of comparable size is not surprising. It can be argued that there is no more reason for a mutual fund to contract out various management services than for General Motors Corp. to make contracts with various managerial groups to perform management services, sales services, and the like for fixed fees unrelated to performance or expense ratios. Parenthetically, I think it would be a curious thing to have an ordinary business corporation operated in that fashion.

The SEC does not challenge the fund structure, however. The modest proposal contained in section 8 that judicial review of such fees as to reasonableness be spelled out is long overdue. Again, in view of the conflict of interest, it would not be unreasonable to impose upon the adviser the burden of establishing the reasonableness of the fee. This, incidentally, is a normal rule as to fiduciaries, that the burden where there is a conflict of interest is upon the fiduciary to establish the fairness and reasonableness of the transaction with the beneficiary.

However, the Commission has made the more moderate proposal of placing the burden of providing unreasonableness upon the person attacking the adviser's fee. Surely if the person can carry this burden, he should be permitted a judicial remedy against unreasonable adviser's fees.

A transfer of control of the investment adviser is related to the problem of fees. If fees are excessive, the price received by the sellers of a controlling block may represent a capitalization of the excessive profits being taken from the fund, and therefore, may be in equity an asset of the fund. The bill proposes to amend section 15(g) to meet this problem. It is made unlawful to transfer control of an investment adviser of a fund, if the terms are likely to impose additional burdens on the fund, limit its freedom of action, or be otherwise inequitable to the fund.

2. *Amendment to section 36—enjoining breach of fiduciary duties.*—Section 36 now authorizes the SEC to bring an action in the Federal court to enjoin any officer, director, investment adviser, and certain other affiliated persons from performing his respective role if such person has been guilty of gross misconduct or gross abuse of trust. The amendment would authorize an injunction against such persons engaged in actions which involve a breach of fiduciary duty to the fund. The fiduciary standard is one the courts understand; it does not carry the taint of gross misconduct or gross abuse of trust, thereby giving the court greater flexibility; and the standard is that now imposed upon broker-dealers and investment advisers under other acts

administered by the Commission. Indeed, this is the common law standard with which all fiduciaries are required to comply.

3. *Front-end load.*—I favor the elimination of front-end load plans as provided in section 16 of the bill. The Commission's analysis of the justification of this proposal is quite convincing. At the present time four leading commercial States prohibit the sale of contractual plans: California, my own State; Illinois, Ohio, and Wisconsin.

And I am sure that the committee has the evidence that California has 22 percent of the sales of mutual funds in the United States, and it is my recollection that it is the largest purchaser of mutual funds, which indicates that funds may be sold without having a contractual plan, and very successfully.

These States have adopted the policy now proposed in the amendment to the Investment Company Act because they feel that the contractual plans by and large are unfair to the small investor.

In California this is by an administrative ruling of the California corporate securities commissioner, which was adopted many, many years ago on the ground that a contractual plan was not fair, just, and equitable to the security holders, and while there were some efforts on part of the industry to get a change in that respect, neither the executive nor the legislature have yielded to this, and this is just not, you know, a question of debate in California today. It is regarded as settled. I refer the subcommittee to pages 15–16 of the SEC analysis of the bill. That was a reference to their report to the Senate, and similarly to the House subcommittee.

I have not in my statement said anything about sales commissions. I feel that the question of sales commissions is an economic question, and not a legal question, but I have reviewed the evidence that was presented before the Senate Banking and Currency Committee, and particularly the testimony of Prof. Paul Samuelson and Professor Wallich, who are eminent economists. I agree particularly with Professor Samuelson that we have in this industry, as the chairman indicated by some of the questions to one of the earlier witnesses, a case of imperfect competition where there is no competition at the retail sales level, because of congressional legislation in section 22(d) of the Investment Company Act; and that the most appropriate solution to restore the competitive situation in the industry would be to repeal that section.

Now the SEC takes a more modest proposal here, and that is that the sales commissions be cut from around 9 percent back to 5 percent. Professor Samuelson's testimony and other testimony indicates that the stock exchange commissions fixed by the stock exchange under supervision of the SEC is about 1 percent, and on an in-and-out transaction would be about 2 percent, so that the cost of selling mutual funds is nine times the cost of direct stock investment. As Professor Samuelson points out, it is quite obvious why a broker-dealer, when given the option of earning nine times or perhaps more than that, if it is just a purchase of direct stock, all other things being equal, and where the customer doesn't have a strong preference, would be inclined to recommend a mutual fund. I think this has generated the enormous growth of mutual funds, and it is very unhealthy from a competitive point of view. It really puts the broker-dealer in a difficult position, and in a position of conflict of interest.

Now Professor Samuelson suggests that particularly the stock exchange commission rate structure, with the give-up practice, which I am sure you are familiar with, where up to 60 percent of the commissions on portfolio transactions of the primary brokers are again funneled back to the stock exchange firm, which sells the mutual fund, which adds to the 9 percent or the 8 percent, or 8½ percent another 4 percent, which really brings it to about 12½ percent on selling mutual funds is quite unhealthy. So that I would favor repeal of section 22(d), or if not, the adoption of the 5-percent figure, which I believe that the industry would be able to live with.

I would just like to add that in 1961 and 1962, when the question of abolishing floor trading came up on the New York Stock Exchange, we heard the argument that this would result in a lack of liquidity in the markets, and dire consequences were indicated, and then we have today 10-million-share days, so that one can't always envisage what the impact of a particular bit of regulation will have upon the industry.

This is a very dynamic industry, and I ventured in my testimony before the Senate to say that after 10 years, if this legislation were adopted, the probabilities would be as in other legislative efforts of the Congress in the securities industry, that the industry would look back on it as being beneficial legislation, whereas at the time they may feel that it would have dire consequences on them.

Professor Samuelson predicts the probabilities of a steady growth of mutual funds in the next decade, but it seems to me that there are great difficulties in the commission rate structure of the stock exchange, and the full commission as it relates to the sales commission on mutual fund shares that is unfavorable toward direct investment as against institutionalization. I think that the Congress itself has favored the institutionalization of investment by adopting section 22(d), and should realize that this is the impact of that legislation.

I will pass on with that to the problem of holding companies.

4. *Holding companies.*—I support section 7 of the bill which is designed to prevent the creation and operation of fund-holding companies and the further enlargement of existing structures of this type. The introduction of the holding company device into the mutual fund field is particularly unwarranted. It would permit those persons who control the holding company to use leverage in other funds so as to exercise an influence over the fund and its managers in ways that are detrimental to outside shareholders. Furthermore, use of the holding company device introduces an additional layer of management charges and administrative costs. Congress has recognized the dangers of the use of the holding company in the public utility field. The mutual fund structure itself provides an additional layer between investor and corporate enterprise. The fund mechanism is justifiable in that it enables investors to pool their investment advice as well as achieve diversification.

The mutual fund structure is presently sufficiently complex without adding the complexities of the holding company. Accordingly, I strongly recommend adoption of this provision of the bill.

In conclusion, I support the goal sought to be achieved by the Investment Company Amendments of 1967.

Thank you very much.

Mr. Moss. Thank you, sir. Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman. I think that the professor has sort of polarized the point of view of the SEC in this matter. We on this committee have to make our judgment as to whether or not you are right and that the industry and the capitalist system and the individual benefit as the result of this legislation as suggested or, as is anticipated by those who are 180° from you, that the legislation will adversely affect our system and the individual who shares in its bounty.

Have you any private practice at the moment, Professor?

Mr. JENNINGS. No. I am presently special counsel to the attorney general of the State of California, in a case now before the courts, but other than that, I am a law professor. I occasionally serve as a consultant both to government and to private parties; that is, attorneys, in a case that is related to my field.

I should have added that I am appearing here not as a representative of any private clients, but on the invitation of the committee, as I indicated. I was a consultant for the Securities and Exchange Commission for 1 month during the special study, and I am coauthor of the leading casebook in securities regulation, and in that capacity I am interested in regulation, and I have regular contact with the Securities and Exchange Commission, and I am not hostile to regulation. But I am not, other than that I am not in any way connected with the Commission.

I may say that, as a matter of principle, I have tried to maintain a position of public interest rather than developing a consulting practice on the side that might make it difficult for me to appear before a committee like this in the way that I would like to do, and I feel that I have been able to maintain that.

But if I do have a bias, I may say that as a professor I am interested in seeing an improvement of the security markets and a fostering of free competition in the United States, and I am a strong believer in our free enterprise system. I think we have a great securities industry. The New York Stock Exchange is the finest auction market in all the world for securities, and I would like to see us foster and preserve that.

Mr. KEITH. I certainly sense that attitude on your part, but I did want the record to show if there was a background which might indicate a bias.

As you have described what has happened in this industry, it seems to me that as it has been outlined by myself and others here earlier, that money managers in seeking ways to get more money to manage, dreamed up the mutual fund approach, and it has been lucrative, and other entrepreneurs have seen the good thing and gotten in on it. It is about as simple as that, both at the management level and at the sales level. If we adopt the suggestions and recommendations that you and the SEC have, it is going to be a less lucrative field. There will certainly still be management companies but there won't be the incentive to start funds that there has been.

In my view thus far it seems to me that the public has benefited by this incentive to get in because of the profits that could be made. I think that the statute with which we are dealing here is wide open to profitable relationships between the fund and the investment company.

That doesn't mean that it is necessarily wrong, if we do get more people into this business.

If they get out and display their wares in a forthright fashion, and don't misrepresent, I think that the effects of the 1940 act are beneficial. Maybe it didn't go as far as it should, but nevertheless we have a pretty good economy as a result of the capitalist system.

I am scanning your testimony as I comment on it. If you would care to correct me to any degree.

Mr. JENNINGS. Well, I would just say that we have here, I think it has to be admitted that the investment adviser is in a fiduciary relationship, but we have in this industry conflicts of interest that no other industry that I know matches. You have the brokers, the portfolio brokerage.

Mr. KEITH. Are they legally in a fiduciary relationship?

Mr. JENNINGS. What?

Mr. KEITH. Are they legally in a fiduciary relationship?

Mr. JENNINGS. In my view, without any question they are in a fiduciary relationship.

Mr. KEITH. I said legally.

Mr. JENNINGS. Yes, I believe so, yes.

Mr. KEITH. Have the courts so held? Hasn't a case been brought trying to prove that point in the State of California?

Mr. JENNINGS. You mean the *I.S.I.* case?

Mr. KEITH. Yes.

Mr. JENNINGS. No; the *I.S.I.* case was a case involving the sale of control by the shareholders.

Mr. KEITH. Didn't the SEC argue that——

Mr. JENNINGS. The SEC argued that that was a gross abuse of trust under the Investment Company Act, and the court held to the contrary on that. This is a question of sale of control.

Mr. KEITH. Wasn't the pitch made that that trust was of a fiduciary nature?

Mr. JENNINGS. I happen to have written in this field myself, and I don't really place much weight on the *I.S.I.* case. I feel that if that case were properly presented, say to the second circuit, you might get a little different result. I would say that in my view that the investment advisers under a management contract—in the first place certainly the directors of the funds are fiduciaries and the directors of the fund have the duty to get the best executions and to get the best advice at the most reasonable prices for the fund, and the point I made was that they do not exercise that, they cannot under the structure, and I think inherently this is very bad, and the courts have not gone into the situation, as I tried to explain, because they fall back upon the structure that is established in the Investment Company Act.

Mr. KEITH. Did the Congress in its report in the last treatment of this subject indicate that this was a fiduciary relationship?

Mr. JENNINGS. You mean the special study?

Mr. KEITH. No; the Congress in its reoprt. You just said in your view under the act which we are now operating there was a fiduciary relationship, and I am asking—I am not an attorney.

Mr. JENNINGS. Yes.

Mr. KEITH. We have been told that there is great store in decision-making, in the committee report and the legislative debate. Was there

any indication in the committee report or in the legislative debate on this matter?

Mr. JENNINGS. I haven't reviewed that, Congressman Keith.

Mr. KEITH. That would be in connection with your studies on the SEC position. You say here on page 5, your comment was that "This is a most curious type of financial structure."

Mr. JENNINGS. That is right.

Mr. KEITH. If, as I understand it, it has been patterned ever since 1940 for this kind of operation, it is well understood by buyers of mutual funds, not the unsophisticated but the more sophisticated buyer, certainly there has been a lot of stress given to this unique nature.

Mr. JENNINGS. You understand why I made that statement.

Mr. KEITH. This is unique to this industry but I would not say it is a most curious type of financial structure. I think it is one that has found great acceptance here and elsewhere.

Mr. JENNINGS. Well, you do find in industry occasionally a company being organized and then a management company contracting to perform the services at a flat fee. That generally has been prevented now by regulation, but the management fee of course is a very nice way of getting away from internalization, but generally in American industry you do not have externally managed companies. You have it only in this particular aspect of financial institutions actually.

Mr. KEITH. But this is the accepted way.

Mr. JENNINGS. Oh, yes.

Mr. KEITH. Now would you maintain that that the internally managed mutual fund executive group are reasonably paid?

Mr. JENNINGS. Yes. I think that the figures I have seen, for instance, take the Massachusetts Investors Trust, where the five trustees get $450,000 a year. I think that compares rather favorably with other types of financial management, and as I understand it, the operating expense ratio and the adviser costs there are about one-third of the cost of an externally managed——

Mr. KEITH. Yes; but the cost to the individual shareholder is relatively inconsequential. What the SEC is trying to get at is the reasonableness of the remuneration to the entrepreneur, and in one case you have an internally managed company where they are making a lot more money than some of the externally managed companies with smaller portfolios, and you are arguing now that they are worth what they are getting because of the size of the portfolio.

Mr. JENNINGS. No. All I am saying is that when you have—this is a form of corporate operation or a business organization, and it seems to me to be really anomalous that, say, a billion dollar fund can't hire directly its management, but has to get an externally managed adviser to do that operation.

This must seem curious even to you. It is so common, however, that sometimes you know we get to the point where what is really anomalous we take for granted, and I think that is the only thing——

Mr. KEITH. I agree that we oftentimes find some things that we have taken for granted yet in retrospect, we wonder how we ever happened to go along with that as long as we did. But if you understand the history of these funds, you realize that the law permitted and encouraged this kind of activity and these people took advantage of it.

Mr. JENNINGS. I only wish to add that since the law permitted it that way, that is why we need this corrective regulation.

Mr. KEITH. I understand. I went to that conference up at the Wharton School.

Mr. JENNINGS. I beg your pardon?

Mr. KEITH. They had a conference at the Wharton School.

Mr. JENNINGS. Yes.

Mr. KEITH. Back in February, I think it was, put on by the bankers and lawyers, if I recall correctly, and there was an attorney up there who bragged about the fact that he received a $500,000 fee in connection with some case that he had presented.

Mr. JENNINGS. Mr. Pomerantz?

Mr. KEITH. Yes. I just wondered if the fee that he got really didn't belong to the fund rather than to the attorney, under your philosophy.

Mr. JENNINGS. Well, you know that——

Mr. KEITH. I mean certainly that would seem to me to be extraordinary compensation to get, if you followed your philosophy; based upon the research and the amount of work that he had to do, couldn't it be held that that fee really belonged to the fund?

Mr. JENNINGS. Well, in connection with fees——

Mr. KEITH. Do you believe a court would have held that fee was reasonable?

Mr. JENNINGS. Well, not only that. The court passed upon that fee.

Mr. KEITH. It did really?

Mr. JENNINGS. In all derivative suit litigation, the court has to approve the reasonableness of the fee, based upon the recovery and based upon the services, and I am sure that Mr. Pomerantz had to file a very extensive bill, and you may know that he had a little difficulty up in Boston in connection with one or two cases there, and the first circuit had to reverse Judge Wyzanski because of certain hostility in that connection.

But I would say that I am perfectly consistent here, that all attorneys' fees in this kind of litigation have to be approved by the court as to reasonableness.

Mr. KEITH. There have been references by other witnesses concerning the proximity of Boston to my constituency and for your information and for the record, the mutual fund men in my district have not bothered to acquaint me with the ramifications of this so far as Mr. Pomerantz or any of the other details are concerned.

Mr. JENNINGS. I didn't mean to——

Mr. KEITH. Oh, you didn't. About all that I know of this whole affair is what I have gotten from reading the Senate hearings and from being here when we passed the amendments to the act in 1964; and as a result of these studies from previous years on the committee.

With reference to the front-end load, you made some observations about California in particular. In the case of California, is not that sales force helped by the investment company in one way or another? Isn't that more like an internally managed operation? Don't the salesmen in those cases make something like an average of $15,000 or more a year?

Mr. JENNINGS. Are you talking about ISI?

Mr. KEITH. Yes.

Mr. JENNINGS. Well, ISI, I don't think is responsible for the front-end load problem, but I think it is true. I never made a study of ISI, but it is my understanding that the biggest profit in ISI is on the sales side of the business. You know funds start from three sources: Brokers who want portfolio business may start a fund; investment advisers who are skilled in advising may form a fund; or an organization that has salesmen or wants to develop a sales force may form a fund, and I think——

Mr. KEITH. And a combination of all three.

Mr. JENNINGS. And combinations. And it is true as I understand it, though this is a matter that could be checked, that ISI depends more on sales commissions than otherwise. They have been very successful in one aspect. They developed a sales force of retired businessmen who had been rather successful themselves.

Mr. KEITH. What I would like to know for the record is whether or not these salesmen for a fund operating in the fashion ISI does have there extra compensation made available to them by reason of the relationship between the investment company and the fund itself? Do you know of any? Why the extraordinarily high income for the salesmen and why the success in California? Is there any knowledge that the committee might have that would enable us to look with favor on the techniques used in California as contrasted to the rest of the country?

Mr. Moss. Will the gentleman yield?

Mr. KEITH. Surely.

Mr. Moss. I stated earlier in the hearings that I intended to develop all pertinent facts on the selling of fund shares in California, and have those available for the committee. I am undertaking to do this study.

Mr. KEITH. I have no further questions, Mr. Chairman.

Mr. Moss. Mr. Murphy.

Mr. MURPHY. Professor, I certainly enjoyed your testimony.

Mr. JENNINGS. Thank you, sir.

Mr. MURPHY. You stated that there was sufficient evidence in the Senate hearings to justify a cutback in sales charges from 9.3 percent down to 5 percent. Was there statistical evidence submitted or was this opinion evidence of the two professors that you had mentioned?

Mr. JENNINGS. Well, neither one presented statistical evidence. It was economic analysis of what might likely occur under this kind of a change in that you have imperfect competition today. They both felt that if there was competition introduced at the retail level, it would be a healthy situation, that probably we have too many part-time salesmen in this industry. You know one of the characteristics of this industry is that salesmen are recruited and they first sell their relatives and their friends, and they go on from there. Many of them drop out at that stage, and I only have a brief sampling myself, but from my own experience it is just curious the number of people who buy mutual funds because someone's brother that they know is selling mutual funds. And I think that mutual funds could be marketed in a much more efficient way.

Mr. KEITH. Cold canvass is a cold business.

Mr. JENNINGS. Yes.

Mr. MURPHY. Professor, it doesn't seem that there has been any indication on the part of the industry to compromise the difference in those figures, 5 to 9.3

Mr. JENNINGS. I gather that from newspapers. They have got section 22(d) and a very big spread here, and I don't think one would expect, as Professor Samuelson indicated, it is not to be anticipated that they would like to give that up. But I think it would be healthy from two points of view. I would like to see more direct investment myself. I would like to see the broker-dealer have a little more option to put people into direct investment instead of mutual funds. I think it would be healthy for the economy.

Mr. MURPHY. Do you think the funds have arrived at the point where they will be bought rather than sold by the investor, and therefore the salesman is not as necessary as he might have been in the earlier development stage of the fund?

Mr. JENNINGS. I really can't answer that. I hesitate to get into these economic questions, because I am just a layman like everyone else, just trying to observe the situation and make some judgments, but I don't have any expertise in that field.

Mr. MURPHY. Thank you very much, Professor.

I have no other questions, Mr. Chairman.

Mr. MOSS. Mr. Watkins.

Mr. WATKINS. Thank you, Mr. Chairman. Professor Jennings, are you in favor of contract sales of funds?

Mr. JENNINGS. Do you mean by that where the person forfeits something if he doesn't make his installments?

Mr. WATKINS. I mean contract sales where a person pays as he goes along, the little fellow who purchases insurance, purchases policies, and he——

Mr. JENNINGS. I think the question is what he loses if he doesn't continue his payments. That is the question.

Mr. WATKINS. Are you opposed to contract sale, yes or no?

Mr. JENNINGS. I am opposed to the front-end load as it is now operated under the investment—as now permitted under the Investment Company Act, which permits 50 percent to go to the salesman, and the statistics show there is a very great forfeiture, and it develops a hard sell and I think it is a very unhealthy thing, and I think we proved in California and in a few other States that it is completely unnecessary.

Mr. WATKINS. You said it is unhealthy and unnecessary. What experience have you had in that? Do you know of losses that investors have had or what? Where do you get this information from, or is this just a personal view?

Mr. JENNINGS. I will give you one example.

Mr. WATKINS. I would like that.

Mr. JENNINGS. Talking to my barber who told me about his brother who had signed up on a $15,000 contract, and he had forfeited out and lost a substantial amount, and I said, "Well, that couldn't possibly have happened. They don't have a front-end load in California." He said, "That is right, but this was in Oregon." And I think that there is quite a bit of statistical evidence that has been presented and studies made as to the impact of the front-end load.

And for that reason, you know at least 30 years ago in California the Commissioner of Corporations decided it was not fair, just, and equitable and simply prohibited it, and the industry has grown enormously as a result of that.

Mr. WATKINS. You talk about the industry growing enormously in California, which I think it has. California is a big State and it is certainly still a growing country. The State of Pennsylvania hasn't had that experience. It has been a growing industry there.

Mr. JENNINGS. I beg your pardon.

Mr. WATKINS. What is that?

Mr. JENNINGS. What has happened in Pennsylvania?

Mr. WATKINS. I am saying it has been a growing industry. It has been accepted and approved by the State laws, by the Securities Commission. We don't have any trouble there.

I would like to know myself what the investors say about this. You have explained the law in California very nicely and I appreciate it, but I don't agree with a lot of your statements and a great many of your thoughts on it. I think this is good and I am just wondering if you can answer this question. I think this is a very good one. Do you think that the SEC should propose a 5-percent rate on this industry? Do you think that is proper?

Mr. JENNINGS. I think that since you have in this industry resale price maintenance by Government action, if that is continued, then it is necessary to have some control of the reasonableness of the sales commissions just as the Government maintains control of the reasonableness of stock exchange commission rates.

Stock exchange commission rates are fixed by the stock exchange, the New York Stock Exchange, subject to oversight by the SEC.

Mr. WATKINS. That is true.

Mr. JENNINGS. In this case it is left to the courts to determine.

Mr. WATKINS. Let me ask you this question. Do you know of any other industry other than those operating under Government franchise, a public utility, that——

Mr. JENNINGS. Well, this is a regulated industry.

Mr. WATKINS. I understood you to say, too, that you considered this not a competitive industry.

Mr. JENNINGS. Not competitive at the retail sales level, that is correct, and I think this was admitted by the industry representatives this morning. Now, when it is a question of whether you have freedom of entry into the industry, there is freedom of entry into the industry, probably more than in most, and a wide range of products of different character offered. That is not the issue.

But the question is whether, for instance, if I want to sell my mutual fund shares, I have to sell those back to the company or if I want to buy, I can't buy them on the open market. If you repeal 22(d), there would develop a market by buyers and sellers of mutual fund shares which would cut that cost.

Mr. MURPHY. Would the gentleman yield?

Mr. WATKINS. Yes.

Mr. MURPHY. Professor, you said you didn't feel that there was retail competition in the sale of mutual funds.

Mr. JENNINGS. On price.

Mr. MURPHY. How about for the selling of one fund versus another?

Mr. JENNINGS. Oh, certainly, but as to price, its retail price is maintained.

Mr. MURPHY. The individual would be subject to subscription by several salesmen, say one salesman representing one fund.

Mr. JENNINGS. Oh, yes; or by a broker/dealer who sells, say 50 funds.

Mr. MURPHY. Thank you.

Mr. WATKINS. Do you know of any other industry where the Government has a——

Mr. JENNINGS. I just want to point out again that this is a regulated industry where you have a structure in effect which is approved by the Congress.

Mr. WATKINS. You are not answering my question. Do you know of any other industry that the SEC puts a fee on?

Mr. JENNINGS. That the SEC is putting a fee on?

Mr. WATKINS. Yes, or setting a fee.

Mr. JENNINGS. Well, so far as Commission rates are concerned, and also so far as Commission rates at the over-the-counter level. They are self-regulated subject to SEC supervision. Now, this bill does not propose that as a solution. This bill proposed that this be left to a court to determine the reasonableness, not of fixed fees, but, you know, a question of whether it is reasonable under the circumstances for the particular company, which is a more flexible——

Mr. WATKINS. It is my understanding, if I am correct, that they would set a fee of 5 percent subject to court.

Mr. JENNINGS. No, on the sales commission you are quite right. I was on the advisers fee. You are quite right; yes, sir.

Mr. WATKINS. I am concerned very much with the little fellow. I think that is the fellow we have to worry about. How can a little man, how can he know about the markets, how would he know what stocks to buy? Don't you think that these mutual funds give a real service to the little fellow?

Mr. JENNINGS. Yes, I think that mutual funds perform a real service, surely. I haven't argued to the——

Mr. WATKINS. Do you know of any crookedness where an investor has been hurt?

Mr. JENNINGS. Well, yes, the managed fund case. It has been, I think, a clean industry, but you asked me do I know of any.

Mr. WATKINS. In other words, what percentage would you say have been hurt, where they have found bad cases—1 percent, 2 percent?

Mr. JENNINGS. No, I think it is a well-managed industry.

Mr. WATKINS. In other words, it is the same as any other industry.

Mr. JENNINGS. No, the securities industry, I think, is probably cleaner than most.

Mr. WATKINS. We know of lawyers who go bad, don't we?

Mr. JENNINGS. Yes.

Mr. WATKINS. What would happen to the small mutual funds? For instance, I know of a gentleman who testified here that he has 240 employees, and he said if this fund is reduced to 5 percent, that they could never pay the salesmen, the management fees, the office fees, the various costs of running this fund. These people would have to be laid

off. Do you agree with that, that a 5-percent fee would put them out of business? Do you know of any firms that would? Not the big fellow now—I am talking about the small fellows. They have a right in this country to earn a living. I am sure you feel the same as I do.

Mr. JENNINGS. May I answer?

Mr. WATKINS. Please.

Mr. JENNINGS. I am opposed generally to resale price maintenance. I believe in the competitive system, and I think that in the competitve world the consumer will be better off and the business will prosper. Now what you have here is a noncompetitive situation by Government action.

Mr. WATKINS. We have a line of disagreement on that, but go on.

Mr. JENNINGS. Well, I think I have answered the question.

Mr. WATKINS. You didn't answer. I asked you what would happen with a 5-percent fee. Do you think that small firms can operate under it? We have had testimony that they couldn't. Now you are an expert in this. I want to know your opinion.

Mr. Moss. Just a moment. The gentleman has not represented himself as an expert and in fact specifically disclaimed expertise. He stated quite clear and unequivocally that he was appearing here primarily on the questions of law involved in the proposed legislation, and it was only as an aside that he departed from his prepared text to make a comment on the load charge, but he clearly said that it was on the legal question, so the record reflects the fact that he is not appearing here as an economic expert.

Mr. WATKINS. Mr. Chairman, am I correct, if I heard the gentleman testify and I made a note here that he thought rates of 8 percent, 9 percent, he even ran it up to 12½ percent.

Mr. Moss. The gentleman is very correct.

Mr. WATKINS. Did he make that stateemnt?

Mr. Moss. The gentleman is correct in everything except his statement that the gentleman represented himself as an expert in that field. He did not. He gave an opinion. He did not represent it as an expert opinion.

Mr. WATKINS. I will reword it. In your opinion do you think they could operate on a 5-percent rate?

Mr. JENNINGS. Well, I don't have any information on that, and what I tried to make clear was that I hesitated, I didn't put anything in my statement on the question of sales commissions, but in reviewing the testimony, particularly of people that I regarded as experts in this field, Professor Samuelson and Professor Wallich, who made an economic analysis of the question of sales commissions, I came to the conclusion that they were very convincing. Now as to whether the figure—I think there is an obvious disparity between the commission rates on direct investment in the stock exchange of a half of 1 percent and 9 percent, and with the give-ups up to say 12 percent in the case of mutual funds. Now my own personal judgment, without any economic data, is that that looks quite out of line. The economic data ought to be developed, but I think it is very much like the chainstore situation, where the chainstore comes in and performs a very important function, but it certainly cuts costs of retailing.

Mr. WATKINS. SEC doesn't regulate chainstores.

Mr. JENNINGS. No, but I point out again that the mutual fund industry operates under really special legislation.

Mr. WATKINS. That as you know, Professor Jennings, you know that—regardless of whether you do or not in this bill, there is the matter of this fee. The SEC is setting this fee. I haven't received too much complaint about this bill, very little in fact other than on this one section.

Mr. JENNINGS. Not the advisers fee so much.

Mr. WATKINS. No.

Mr. JENNINGS. Well, I am sure that——

Mr. WATKINS. The biggest complaint is that we are going to put a lot of pople out of business if we put this 5-percent fee on under which they say they can't operate.

And another thing, the SEC has the power to do it. I think somebody is certainly going to take that to court. Why do they pick this one industry to pick on? Why do they jump on them and let everybody else go? Now just as to my own thinking, you buy an insurance policy and you pay a year's premium on it, and with a life insurance policy what do you get back if you are not able to pay it off the second year? What happens to the first payment you make?

Mr. Moss. The gentleman knows that the SEC——

Mr. WATKINS. I am just asking the question. Why don't you let me go on, Mr. Chairman? It is only going to be a second. This is a comparison here.

Mr. Moss. The insurance industry is not subject to any regulatory action by the——

Mr. WATKINS. That is just what I am trying to get to, Mr. Chairman, and I want him to tell me——

Mr. Moss. The question you asked is why does the SEC pick out this industry.

Mr. WATKINS. Right.

Mr. Moss. It picks out the industry because it is charged by law with regulating this industry.

Mr. WATKINS. What happens to me, I will ask you if you don't want him to answer it, what happens to me if I purchase an insurance policy, a straight life policy, and I pay $300 the first year?

Mr. Moss. It depend on the laws of your State.

Mr. WATKINS. What happens in California?

Mr. Moss. Well, I am not going to undertake to respond to that. This is not a committee on insurance.

Mr. WATKINS. I have had experiences that I know, not personally but I know of people who have paid the $300 and if you didn't pay the second year he lost the fee.

Mr. Moss. For the gentleman's information I have quite a number of letters up in my office which I shall be pleased to put in the record from buyers of mutual funds or shares complaining bitterly about sales charges and of the losses they have sustained not only when they have cashed out early, but as a result of the failure of the funds to perform as indicated. Now if the gentleman wants that material in the record, I will be most pleased to put it in.

Mr. WATKINS. Mr. Chairman, I would be delighted to have it in the record, because I don't have any such complaints.

Mr. Moss. I will be very happy to hold the record at this point and respond to the gentleman's inquiry by placing those letters in the record.

(The letters referred to follow:)

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., November 6, 1967.

ED WILLIAMSON,
Clerk, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR ED: During the proceedings of the hearings on HR 9510 and HR 9511, I assured my colleague from Pennsylvania that I would submit, for the record, letters which I have received from individuals across the nation concerning the subject under consideration by the Subcommittee.

I would appreciate it if you would include the attached letters in the official transcript of the hearings.

Sincerely,

JOHN E. MOSS,
Member of Congress.

ALEXANDRIA, VA., *October 4, 1967.*

Representative JOHN E. MOSS,
Chairman.

DEAR MR. MOSS: It is my hope that your committee will take some positive action to reduce the fees, and more important the commissions I pay on mutual fund purchases.

I am buying shares in Manhattan Fund, with a plan to use them for Retirement about 10 years away. Each month, some salesman gets (8%) of my savings from now on, even though he no longer does anything to serve me. I send my checks to the bank, and they send me a receipt after sending him 8% for nothing!

Doesn't seem quite fair for so many years to come. Seems to me that 3% or 4% would be plenty for his small original effort.

Thank you.

H. T. MAULDING.

OCTOBER 19, 1967.

DEAR REPRESENTATIVE MOSS: Mr. Haack (Pres. NYSE) is plunking for hands off the racket.

If the funds would police themselves, obviously you wouldn't be having your hearings. Do the crooks police themselves? The distortions and dangers, the Funds are causing in our securities markets, may yet lead to serious trouble.

Besides, with their constant accumulation of money, they are pricing American shares out of reach of the public, who should be able to invest at reasonable prices. These stocks are not poker chips—they represent the ownership of our companies and if the people can't buy them, we have lost a freedom.

The NYSE will sponsor anything that makes money for their members, but show little concern for the public.

Inside & advance info—kickbacks & payoffs for info not available to legitimate stockholders & much more I know nothing of, but is obviously there—pool operation—collusion between Funds—you name it—it is happening every day & the SEC is reluctant to interfere. Maybe they are being carried in some swinging stocks.

You *should* put the NYSE under some meaningful control, as they are advertising for public participation. They are an unconscionable monopoly & should be controlled like AT&T or the utilities or railroads.

Sincerely,

F. SANDERS.

P.S. I am writing this because the little fellow seems to have no voice with you people. These Funds buy on advance info & dump, leaving the little guy stuck.

Where are the marrying, partying Johnson's sacrifices?

What is it with you guys?

War on & boys dying, yet you—

1. Let Wall St. & the NYSE go on a gambling binge that may wreck the country & surely helps cause inflation.

2. Refuse to make large companies that benefit from war orders bear their share of the burden.

3. Refuse to close tax gimmicks for the rich & their foundations.

4. Refuse, for the 1st time in war, to have wage & price controls.

5. Refuse to pass plain decent conduct laws for Congress but pass salary & travel boosts at such a time.

Mister, I've seen crumbs & bums but my leaders win. Why don't you let the Swiss run our gov't? They take over when we don't talk to someone. And they don't steal.

FLUSHING, N.Y., *October 14, 1967.*

DEAR REPRESENTATIVE MOSS: I am writing to you as one small Mutual Fund investor, out of the 3½ million banking on you as "Representative" of the people to wage the good fight against the powerful vested interests of the Mutual Fund Industry.

For example dividends are a *natural* accretion of investment and risk. Why does my very profitable Putnam Growth Fund charge me 8½% for my dividends? This is simplest bookkeeping item with *no salesman ever involved!*

Actually as a well read individual I did my own research and wanted to buy directly from Mutual offers because I *wanted* and *needed* NO salesman. Yet I was referred to brokerage house and had to pay a substantial load for Dreyfus, Fidelity Trend and Manhattan regardless. Why?

Again the relative range of operating expenses and costs among the over 300 Mutual Funds are astounding and shocking. Why should Revere have expenses of 95.7% of income whereas Mass. Inv. Trust has only 5.9% of income. My own personal Tri Continental has about 2.% and are of lowest in industry. Size may be a factor but certainly legislation seems in order.

Both my Dreyfus & Putnam Gr., as well as many others have identical men both as trustees of Fund proper, and also as directors of separate financial management of same Fund. Most are honest, but human nature being what it is—a serious conflict of interests could well arise. It would, I feel, always be decided in favor of directors *not* the small investor.

Compare the huge salaries and bonuses paid to managers of Funds to your own salary. Why this outlandish disparity? Why shouldn't there be a fair salary ceiling with the rest to small investors who also partake in risk.

Why should average sales load of Mutual Funds be 9.3% of net—so much higher than all other media of investment?

We ask you to support S–1659 the Investment Co. Amendments Act of 1967 as *representative of the people.*

Cordially,

SAMUEL G. GILBURT.

PITTSBURGH, PA., *October 17, 1967.*

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

DEAR CONGRESSMAN MOSS: Thank you for challenging the role of salesmen in the sale of mutual funds. Just a few months ago I invested in four funds after considerable research. All the brokerage did was sign the application blank and continue to collect fees.

A very good friend of mine did precisely the same thing and so do other serious investors. Our judgments after examining prospecti are as good as theirs.

Very truly yours,

ARTHUR W. AYARS.

WESTWOOD, N.J., *October 14, 1967.*

MY DEAR MR. MOSS: I think that you are doing a fine job investigating the mutual funds.

If you get into it deeply you will find plenty of Hanky Panky in what they do. Who is to protect the small person who invests his life savings in these funds, and then is disappointed when he finds out the bitter truth.

Please continue your good work and see that the laws are tightened up on the entire securities industry.

Sincerely,

IRVING LEIBOWITZ.

DOVER, DEL., *October 21, 1967.*

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

SIR: My husband and I have followed with great interest the SEC recommendations on mutual funds and more recently, the House Commerce subcommittee investigation.

A recent New York Times report (10/14/67) dealt primarily with the sales commission charged by the majority of funds. The NASD and the mutual funds argue a reduction to 5% would seriously reduce their sales force and stress the services rendered by the salesman.

The average investor has no lobby to speak for him and to protect his interests. We feel compelled to write of our experience, which is undoubtedly a common one in hopes that it will give you the "other side of the picture"—the investors'.

In June of 1960, we heard of a reputable mutual fund salesman through my husband's co-workers. We asked the gentleman to contact us, and he did. On an appointed evening, he came to our home and gave us an excellent indoctrination into mutual funds, their differences, and past performances. (This last was a large reference volume with all available funds included.) He left us with the prospectus for three funds, and appropriate application blanks. We chose to begin investing in Massachusetts Investors Growth Fund and have continued regular periodic investments (completely voluntary) ever since. We also reinvest all dividends and capital gains. Over the 7-year period we have been satisfied with the growth of our investment and the management of the advisory board.

Our one dissatisfaction is with the sales charge. We never saw our salesman again after the first evening—there was no need as the investments are made by mail. He has never rendered any services of any kind. Our only contact is a Christmas card from him once a year. Our cash investments have totaled $6,700 and our dividends $463+. At the present 8½% sales charge, we have paid $608+ for one evening's counseling—and shall continue to pay with all subsequent investments. This is an absurdity and all out of proportion.

We suggest that the mutual funds, if they are good enough, do not need to continue to "sell" the regular investor. Let them pay their salesmen a regular salary, or a commission on new investors, but after a period of two years or so, the long-time investor should not be penalized with the exorbitant sales charge for *no* sales services rendered. No one sells us; we sell ourselves.

With hopes for an equitable solution to these problems, I remain.

Yours truly,

CHARLENE S. TROCHTA.
Mrs. Joseph F. Trochta.

ARLINGTON, VA., *October 26, 1967.*

DEAR MR. CHAIRMAN: I strongly support your bill to abolish front load mutual funds and reduce the cost of mutual funds from nine to five percent. Small time investors should be encouraged to invest in the securities market and a cost reduction is one way to attract such people and at the same time add vitality and strength to the securities market.

Presently I have two separate plans for the fractional purchase of shares with the Quinby Company of Rochester, New York. The Company's Quinby plan is both a front load plan and its cost is about nine percent. Please advise me whether the Quinby Plan offered by the Quinby & Co. Inc. of Rochester, New York will fall under the jurisdiction of your bill as the company is set up for the fractional purchase of shares and not a mutual fund.

The attention of your subcommittee or the Secuirties Exchange Commission to this matter will be appreciated.

Sincerely,

BOHDAN WENGLOWSKYJ.

TENAFLY, N.J., *October 27, 1967.*

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

DEAR MR. MOSS: As an owner and continuing buyer of mutual funds, I applaud your handling of the hearings on mutual funds.

I think a 5% load charge is more than adequate. I also believe that management fees are in some cases much too high. Some ceiling should be placed on them.

Yours very truly,

CHARLES P. O'KANE.

Mr. WATKINS. That is exactly what I know. I want to know what the purchaser is saying. I appreciate that the distinguished gentleman is here to testify and you have done well, it is wonderful. Certainly you are enlightened in the law. You are a very smart man. Your testimony shows that. I haven't regretted anything that he has to say. It is his feeling.

But I do have a feeling about this bill, and I don't think this 5-percent fee is right. I don't think the SEC has any right to put it on, and if they put it on these people I want to see them get into other categories.

Mr. Moss. The gentleman is eminently correct. The SEC has no right to put it on and that is why they have suggested to this committee that we consider the advisability. It is finally our responsibility and our determination not the SEC's, and they haven't proposed to usurp the authority of the Congress or of any other interests. That is not the question pending before this committee.

Mr. WATKINS. May I say to the gentleman that I thank you, even though the chairman wouldn't let you answer my question. He finally did it but I think we have a friendly understanding. I certainly appreciate what I have read here. If I understand it, the chairman might like to write to you in the period of a week and ask you questions about some of your testimony, is that correct?

Mr. Moss. That is correct.

Mr. WATKINGS. Thank you very much, and thank you.

Mr. JENNINGS. Thank you.

Mr. Moss. And thank you very much.

Mr. JENNINGS. Thank you very much, Mr. Chairman.

Mr. Moss. I appreciate your taking the time to travel here to Washington to respond to the interests of the committee.

Mr. JENNINGS. It was a pleasure.

Mr. Moss. The next witness will be Mr. J. A. Livingston, financial editor of the Philadelphia Evening Bulletin. Mr. Livingston.

Mr. WATKINS. Mr. Chairman, may I be excused?

Mr. Moss. You may be, sir.

Mr. WATKINS. I would like to hear Mr. Livingston but I have to leave.

STATEMENT OF J. A. LIVINGSTON, FINANCIAL EDITOR, PHILADELPHIA BULLETIN

Mr. LIVINGSTON. Mr. Chairman, most mutual fund salesmen are honest and serious in their effort to assist investors in using savings wisely. But they are subject to a double pull—their self-interest against

the interest of the investor, often a person unskilled in finance or economics.

This conflict is inherent in the stock and bond business. Wall Street manufactures securities for sale. A securities salesman has the job of persuading investors to buy the merchandise which is for sale. Yet, at the same time, he tries to advise investors on what is best for them.

Thus, he wears two hats—the hat of the salesman, anxious to earn a commission and the hat of the investment counselor, or adviser, duty-bound to help his client or customer. When the showdown comes, whom does he serve—his wife and kiddies, or the investor's wife and kiddies?

It is argued that full disclosure protects investors buying mutual funds. But what does full disclosure provide? It tells how much a particular fund charges. It does not mention alternative investments. It does not indicate that the investor can buy mutual funds without a sales load—with no commission whatever. It does not mention closed-end funds selling at a discount.

And if a salesman is asked about a no-load fund, he tends to parry the question, by saying: "Well, you know you get what you pay for in this world"; or, "Often no-load funds have a redemption fee instead of a sales fee"; or, "No-load funds have higher management fees and they have to be paid year after year."

These are not even half-truths. So there is not full disclosure orally.

It is also argued that competition protects investors. But competition has worked the wrong way. Sales commissions have tended to increase over the years toward the highest level. Sales organizations early discovered that they fared best by raising commissions. The evidence on this is on page 208 of the SEC report to this committee, dated December 2, 1966.

This is human nature. The customer's man in a brokerage office or the independent salesman tends to push the stock or bond which yields him, the seller, the greatest return. The recent sale of dual-purpose funds in Wall Street suggests this. The commission was about the same as that on mutual funds. Many of these funds were oversubscribed—because of the intensive sales efforts.

But now the capital share of six out of seven of these funds are selling at discounts from their net asset value. In terms of real worth—getting assets for one's money—each is a better buy than a mutual fund. But Wall Street has lost interest in selling them. Salesmen have gone back to the greater return—mutual funds.

I think this was a point that Professor Jennings tried to indicate. The SEC proposals have been described as utility-type regulation. There is validity in this statement. The mutual fund industry, as it is constructed, is like a public utility.

The prices are fixed. The fund is protected against price cutting. There are no discount houses in mutual funds. If the funds are protected against unfair competition then the investors should be protected against overcharging.

To support these comments, I am including four recent articles I have written but which I won't read.

As I see it, the buyers of mutual funds, for the most part, are unsophisticated investors with limited savings. They turn to mutual funds because they want a diversified holding of securities, super-

vised—managed—by experts. As small investors they need more protection than the salesman who contacts them.

Mutual fund sales charges are far out of line with the cost of purchasing most securities. The salesman takes no risk whatsoever. Neither does the broker nor sales organization. On most normal transactions, 5 percent is considered a maximum reasonable brokerage or sales fee. The standard sales load on most mutual funds today is far above that. As has already been indicated, it is about 9 percent.

As for the front-end load contractual commission, it is so high as to approach the unconscionable. There is no justification whatever for charging a sales fee on an investment that is to be made in the future.

I might add in response to some of the last questioning that I don't think it is the duty of the SEC and Congress to protect salesmen in this industry. The responsibility is to protect the investor who is putting up his savings and doesn't know in all cases exactly what he is buying and is dependent upon what the salesman tells him.

Mr. Moss. Mr. Livingston, would you like to have these four columns included as part of your testimony?

Mr. LIVINGSTON. I think that would be very nice if you would be so kind.

Mr. Moss. Without objection, then, this will be done.

(The articles referred to follow:)

THE BUSINESS OUTLOOK—AUNT NELLIES STIMULATED NO-LOAD MUTUAL FUNDS

(By J. A. Livingston)

False ideas about mutual funds abound—particularly about no-load funds, those that don't charge a sales commission. My recent series on load versus no-load funds brought questions from hundreds of readers. Here, synthesized, are the questions most asked—with answers:

Q. About two months ago I purchased two well-known mutual funds. Then I read your articles pointing out that in a no-load fund all the money invested goes to work, whereas in a load fund the commission is taken out first. Should I sell my load fund and switch the money into a no-load?

A. No. You have already paid the sales commission. You don't gain anything by disposing of the shares you already own and shifting to a no-load. Additionally, you'd have tax complications: Capital gain or loss?

HARD TO SELL?

Q. I attended a meeting of investors and someone raised the question of no-load mutual funds. The speaker said we'd have a hard time buying them and an even harder time selling them because no broker would touch them. Is that true?

A. It is true that brokers rarely deal in no-load funds. There's no money—commission—in them. Therefore, such shares have to be bought by writing directly to the funds.

It is totally untrue that a shareholder in a no-load fund will have a hard time cashing in his shares. No-load funds, like load funds, are required to redeem shares at a net asset value. This can be done by tendering shares to the fund—in writing.

Q. How does a no-load mutual fund defray its sales costs?

A. In theory, there are no sales costs. In theory, no-load funds are sold "over the transom," or by word of mouth. One person tells another. The origin of no-loan funds is pertinent.

Many no-load funds are operated by investment counsel firms. These firms supervise accounts of $100,000 or up for well-to-do clients. Such clients often have Aunt Nellies who need lots of investment help for small amounts of money—$5,000 or less.

HOW THEY ARE SOLD

Investment counsel can't give personal attention to sums so small. At the same time, they can't say "No" to Mr. Well-to-do. Decision: Put all the Aunt-Nellie money into a common pot—a no-load mutual fund. New money comes into such funds through clients with Aunt Nellies or from satisfied Aunt Nellies or recommendations of Aunt Nellies rather than door-to-door selling.

Some no-load funds advertise. They earn fees on assets—the money that goes into the mutual fund. As the fund grows, the greater the management income. Such advertising, however, is not paid for out of dividends or interest earned by no-load funds any more than the advertising of load funds comes out of earnings. The underwriters, or sponsors, of the funds pay for the advertising.

Q. How can I determine which are the load and which the no-load funds in quotations in the newspapers?

A. The no-load and the load funds are readily differentiated. Most newspapers publish bid and asked prices on fund shares. The bid price is how much the fund will pay investors for its shares. The asked quotation is the price at which the shares are sold to the investor.

THERE'S THAT SPREAD

In a load fund, there is a difference—a spread—between the bid and asked prices. Dreyfus Fund was recently quoted at $15.13 bid and $16.51 asked. The difference, $1.38, is the sales commission or load. Wellington Fund was $13.63 bid and $14.80 asked. The load here is $1.17 a share.

In the case of no-load funds, there is no spread between bid and asked prices. Thus, Loomis Sayles Mutual Fund was recently quoted as $13.23 bid and $13.23 asked; and Stein, Roe & Farnham Balanced Fund was $22.04 bid and $22.04 asked.

The Bulletin separates the load and the no-load funds in its tabulations. This is not the general custom.

(This is the first of three Q. and A. columns on mutual funds. The second will appear tomorrow.)

Reprinted From the Evening Bulletin, September 5, 1967

THE BUSINESS OUTLOOK—MUTUAL FUND PROMISES SHOULD BE IN WRITING

(By J. A. Livingston)

More questions and answers on mutual funds:

Q. It has been suggested that no-load funds are parasites, that people would not know about them if salesmen for the load funds did not explain the possibilities of mutual funds as long-term investments.

A. There is justice in that. Mutual fund salesmen have done an important job in selling Americans on common stocks. Many persons, who bought mutual funds ten, 15 and 20 years ago have reason to be grateful that a salesman rang the doorbell.

Some of this selling spilled over to the no-load funds—naturally. The salesman sold a no-load fund—unintentionally and without reward. That happens in every business. The salesman who persuades a customer that she needs a vacuum cleaner may discover later that she has bought another make. C'est la vie.

Q. Why do you think that it is necessary for Congress to reduce the sales commission on mutual funds? The mutual fund industry is highly competitive. It's not a monopoly. There are hundreds of funds, including no-load funds. Investors, therefore, have a wide choice. The prospectuses are explicit on the amount of the sales charge. Does the investor need more?

COMMISSION SEEMS HIGH

A. To me, the usual sales commission, which amounts to 9.3% on the money which goes to work for the investor, seems high. I grant that a salesman who spends time explaining the merits of a mutual fund is entitled to remuneration. But, no-load funds are available and the National Association of Securities Dealers has usually regarded 5% as an adequate maximum reward for selling over-the-counter securities.

The broker or dealer handling mutual funds takes no underwriting risk. The shares are "created" after the sale.

The fact that the prospectus is explicit on the sales charge is not relevant. Most mutual fund buyers are inexpert—and not comparison shoppers. They rarely read prospectuses. They rely on the oral statements of salesmen, which are not cleared by the SEC.

ABSOLUTELY INCORRECT

Q. Is it correct that the management fees of no-load funds are invariably higher than those of the load funds and that is how the no-load funds make up for the absence of a sales commission?

A. Absolutely incorrect! The management fees and sales charges are distinct from one another. The sales commission goes to the salesman and the organization he represents. The usual charge is about $85 per $1,000. After the commission is taken out, the management fee, or percentage, is levied on the $915 that the managers of the fund handle. On the purchase of the same amount of no-load shares, the management percentage applies to the full $1,000.

Some very large load funds have extremely low costs. Among these are Massachusetts Investors Trust and National Investors with expense ratios of 0.19%. This includes all costs of operating the fund, as well as the fee for management.

RELIABLE ASSURANCE?

The expense ratios of the larger funds—load and no-load—range from about 0.4% to 0.6%. The average expense ratio for all no-load funds with assets of one-million dollars or more amounted to 0.82% last year; of all load funds 0.76%. Clearly then, expenses of load funds are not decisively lower per dollar at work than those of no-load funds.

Q. I have been assured that if I put my savings in a mutual fund my money will grow faster than if I kept in in a bank or in savings bonds. Can I rely on this?

A. Get whoever said that to put it in writing! Rarely does the income from a mutual fund's investments exceed 3%. This is less than the interest on savings deposits or on savings bonds.

Moreover, mutual fund shares represent risk investment—mostly common stocks. These sometimes decline in price. Money is safer and income surer in the bank or in savings bonds. Only during periods of long prosperity can an investment in a mutual fund be counted on to outearn compound interest. The slow, steady tortoise sometimes beats the hare.

(This is the second of three Q. and A. columns on mutual funds. The third will appear tomorrow.)

Reprinted From the Evening Bulletin, September 6, 1967

THE BUSINESS OUTLOOK—NO-LOAD MUTUAL FUNDS: BROKERS SKIRT QUESTION

(By J. A. Livingston)

This is the third and last column on questions frequently asked about mutual funds.

Q. Is it true that if I buy a mutual fund which doesn't charge a sales commission, I'd have to pay a getting-out charge?

A. A few no-load mutual funds—less than one out of four—may charge redemption fees. Rarely do these amount to more than 1%. This is small compared to the usual 9.3% getting-in fee on a load fund.

The redemption charge is designed not to make money but to deter in-and-out trading. The prospectus or sales literature will indicate if there is a redemption charge.

Q. I told a mutual fund salesman recently that I was interested in a no-load fund. He applauded, saying I was wise to buy a mutual fund for long-term investment. Then he instilled doubt. He asked: Have you considered the greater investment flexibility of load funds over no-load funds—especially in a weak stock market?

Because salesmen are actively selling, he said, a load fund has a steady inflow of new money. This means it can reduce its proportionate holdings of common stocks merely by holding on to incoming cash. He said, however, that a no-load

fund does not receive a large cash flow from sales. Therefore, it would have to sell some of its holdings, possibly at a loss, to reduce its common-stock risk. Is that correct?

SIZE VERSUS FLEXIBILITY

A. Hardly. Most load funds are larger than no-load funds. Consequently, the cash inflow through selling would be larger than to no-load funds. But proportionate to size, there is no great difference. This is borne out by two separate statistical studies, one covering all funds by the Investment Company Institute, a trade association consisting largely of load funds, the other based on the sales of the ten largest load and the ten largest no-load funds.

Conclusion: No-load funds have as great a flexibility in declining markets as load funds. Indeed, it can be argued that they have greater flexibility. They are smaller. Therefore, they are not laden with large blocks of shares which might be hard to dispose of during a decline. And though they don't have salesmen pushing their shares, satisfied investors often become "salesmen."

Q. I have been accumulating shares in a mutual fund under a front-end load contractual plan. The salesman explained that half of my first year's payments would be sales commission. But I didn't know of the existence of no-load funds until I read your column. Should I discontinue my plan now, considering that I've already paid a substantial part of the commission?

DOVETAILED INSURANCE

A. This is a matter of arithmetic and judgment. If the fund you purchased has an excellent record, you may want to keep on with the plan even though you continue to pay commissions. After the first year, the commission generally amounts to 3% to 4% on each payment. On large amounts, it's less.

If a no-load appealed to you, you could make a contract with yourself to buy it periodically. Then by dropping the contractual plan, you'd save commissions.

Contractual plans often offer an option—group term life insurance which declines automatically as the investor's payments cumulate. This adds to the cost but is a feature many persons like. It assures completion of payments in case of death. You, yourself, can buy term insurance but the amount would not dovetail exactly into your investment plan.

Q. Where can I get a list of no-load funds? I've asked customers' men several times but they seem not to hear or they change the subject.

NO-LOAD LIST AVAILABLE

A. This is understandable. Brokers make no money on no-load funds. I can provide names and addresses. Send a self-addressed, stamped envelope, marked "No-Load List" to J. A. Livingston, The Bulletin, Philadelphia, Pa. 19101.

Q. Do you consider mutual funds a good investment for the average investor?

A. Yes. For the person who prefers to let someone else manage his money, the mutual fund is an excellent way to purchase a diversified stake in American industry. But a word of caution is in order. Common stocks entail risk.

The United States has enjoyed unparalleled prosperity since the end of World War II. Common stocks have appreciated 500%. There is no assurance that this will continue or be repeated.

In selecting a mutual fund, load or no-load, the buyer must carefully consider which type of fund he wants—a go-go-go speculative venture or a balanced investment in long-term American progress.

(Last of three articles.)

Reprinted From the Evening Bulletin, September 7, 1967

[From the Evening Bulletin, Oct. 19, 1967]

THE BUSINESS OUTLOOK—ARE MUTUAL-FUND BUYERS LIKE UTILITY CUSTOMERS?

(By J. A. Livingston)

William Van R. Cadmus, head of a Livingston, N.J. firm handling mutual funds and various types of insurance, feels that I "have done a great injustice" to mutual funds. He writes:

"For some 20 years, I have sold mutual funds to clients who wanted a sound investment medium. I have always picked the top performing funds and although we know that the past is no indication of the future, a good fund will usually continue to do well.

"A retired school teacher put $16,000 in a fund a little over 10 years ago. She started to withdraw $100 a month at that time. She recently called me to state that she was 75 years old and despite the withdrawal of 7½% a year, her fund was worth $21,000. She is now withdrawing $125 a month and I doubt that you could convince her that a mutual fund was not a good investment.

"I have had clients telephone as a result of your articles to ask if they should withdraw their money from mutual funds and put it in a savings account or a 'no-load' fund. It would be very difficult to find any 10-year period going back over the past 20 years in which a good mutual fund did not show better results in income and growth than a bank account with compound interest."

NO POINT IN SELLING OUT

I agree with Mr. Cadmus. Many persons, who bought mutual funds ten, 15 and 20 years ago have reason to be grateful that a salesman rang the doorbell.

But this doesn't mean that history will repeat. Since 1947, stocks have increased 500%; since 1957, 130%. Will that happen anew?

And I can understand Mr. Cadmus' perturbation when clients—suddenly learning of the existence of no-load funds—want to get out of load funds. The same question has been put to me and I have answered:

"You have already paid sales commission. You don't gain anything by disposing of shares you already own and shifting to a no-load fund."

NO PRICE CUTTING ALLOWED

But these answers—these agreements with Mr. Cadmus—beg the fundamental question: Are sales commissions on mutual funds too high? Should the Securities and Exchange Commission have power to reduce them from the customary 9.3% to 5% as proposed in legislation before Congress?

H. Lawrence Bogert, president of the Investment Bankers Association and a partner in the influential investment firm of Eastman Dillon, Union Securities Co., is emphatic in saying: No. In testimony before the House Subcommittee on Commerce and Finance, he likened the SEC's proposal to "utility-type regulation of charges and profits."

There's validity in this—and justification. Each fund has a monopoly over its own price. The law prohibits securities dealers from trading with the public in mutual funds by cutting the sales fee. These are price-fixed securities.

WHY THERE'S REGULATION

Mr. Bogert notes that many companies and many salesmen offer mutual funds. So there is competition among funds for sales—for volume. But competition has not pulled sales charges down. It has tended to drive them up. Why? Because salesmen tend to push merchandise that yields them the greatest reward.

Most investors in mutual funds are not experts in finance, investment analysis or bookkeeping. They rarely read prospectuses or shop for value. They put their trust implicitly in the salesman.

To assure that this trust is not abused is a responsibility of Congress and the SEC. This is in accord with the spirit of the securities laws.

Naive and trusting investors are much like householders who purchase electric power, telephone service, or gas from a franchised utility. That's why we have utility regulation. That's why we have SEC regulation.

Mr. Moss. Mr. Keith.

Mr. KEITH. Thank you, Mr. Chairman.

Mr. Livingston, I have read your articles ever since I have been on the Washington scene, and I think they are helpful to us in the Congress in comprehending what is going on in the financial world.

Mr. LIVINGSTON. Thank you very much.

Mr. KEITH. Before coming to Congress I was a salesman for the Equitable Life Assurance Society, and it is one of these regulated in-

dustries, where there is at least some of the same kind of price fixing as has been pointed out here. It is, however, very competitive. I would like to say in defense of the salesman, you have stressed or implied when the showdown comes—"Whom does he serve, his wife and kiddies or the investor's wife and kiddies?"

He serves his own wife and kiddies best and himself best to the degree that he can win, hold, and deserve the confidence of the customer on whom he is calling, and I do commend to your attention the book "A Fortune To Share," by Vash Young.

As I said earlier, in these hearings, this was given to me when I graduated from prep school in 1934 by the master of the academy. Admittedly a lot of salesmen start off selling to their friends, but they are not going to do a job on their friends, and if they did I would say that this is not the successful man in the long run.

Mr. LIVINGSTON. May I comment on that?

Mr. KEITH. Certainly.

Mr. LIVINGSTON. There is no doubt that the successful salesman in any business serves his clients, but in many businesses, particularly when you are young, you have got a very strong pull to earn commissions, and in the insurance business an analogy that has been used by Mr. Day and by other persons doesn't seem to me entirely appropriate.

First, it is very hard to buy insurance without paying a commission. It is possible to buy funds, mutual funds, which do just exactly the same jobs of these load funds that charge a commission of 8½ to 9 to 9.3 percent without paying a commission. So there exists competition. In New York and in Massachusetts people can buy insurance without paying a commission, in one other State——

Mr. KEITH. Connecticut.

Mr. LIVINGSTON. Connecticut, so therefore there isn't the same situation. The investor in mutual funds has alternatives. Furthermore, the salesman in the securities business does have a semifiduciary relationship to the investor, the person he is meeting, and that is why the SEC has introduced the rule of suitability.

You have got to pick investments which are suitable to the financial and economic and social status of the individual, and the salesman could very well offer a no-load mutual fund or he could offer a closed-end fund selling at a discount, but because the commissions are so much higher on mutual funds, the temptation is terribly great to sell the mutual vis-a-vis these alternative investments. I am sorry to make such a long speech.

Mr. KEITH. That is all right.

Mr. LIVINGSTON. But on insurance it is said that the front-end load is 50 percent. But if you read Mr. Day's testimony carefully, you will notice that he says that the cost of writing the insurance the first year is frequently not enough to pay the salesman, and therefore the company has to take some of this money out of its surplus to do so. So it isn't the purchaser of the policy that pays the full commission in the first period.

But when you buy a mutual fund on the contractual plan, and you pay 50 percent in the first year, it is the investor who is paying all of the money, and his investment, his money, is not going to work. Why should a person pay in advance for an investment he hasn't made? I am sorry, I didn't mean to ask you a question.

Mr. KEITH. I guess we could really explore this at some depth and I would like to, but I think it would be a rather long procedure, because we have several areas in which we have differences of opinion.

Mr. LIVINGSTON. Mr. Congressman, may I add this. On annuities in an insurance plan, if I am correct, which is much more comparable to a mutual fund contractual plan, the sales commission in the first year is only 15 to 20 percent, or 10 to 15 percent, according to a book by Dan M. McGill, "Life Insurance."

Mr. KEITH. Well, we have heard here about books pro and con. Figure lie and liars figure.

Mr. LIVINGSTON. Well, I am trying not to lie.

Mr. KEITH. I know. And I don't mean Mr. McGill has done that, but the compensation for selling an annuity is not as great as for selling life insurance, and there are probably adequate sales and social reasons for that. But let me just say this, to get specific here, and I am not agreeing with all that you have said. We can pursue it perhaps at a later date when I get the record straight between us.

On these no-load funds, the law, it seems is quite specific. It prohibits them spending any money on sales if they conform in other respects to the basic law. I would think that if we loosen up that section to permit no-load funds to advertise in the way savings banks do in Massachusetts, that the public would have these facts which you now are afraid they don't have.

Mr. LIVINGSTON. They advertise.

Mr. KEITH. They don't advertise except institutional ads. They don't really try to motivate people to come in. They don't say "Buy a no-load fund and save the agent's commission." They don't say "Do it yourself and save money." They just advertise the fact that they are a no-load fund, as I recall the advertisements.

I am talking about more motivating sales literature mailed out to the prospects, and through the financial sections of the newspapers and magazines. They might loosen up a bit and get somewhat away from the no-sales load to some sales load to cut out the agents to some extent.

Now I in taking your advice bought a no-load fund, and it was one of these where you buy it at a discount. I guess that is the term used.

Mr. LIVINGSTON. Well, that would be a closed-end fund.

Mr. KEITH. It was a closed-end fund. And I sold at a discount.

Mr. LIVINGSTON. That is right.

Mr. KEITH. That brought a factor into play that I didn't really count on, but I wasn't an authority in this field. I didn't buy, as I hoped to simply a cross section of a diversified portfolio. I had that discount on the way in and on the way out.

So these no-load funds are of two sorts. You have the closed end and the open end, and those that are sold at a discount you don't necessarily get what you think you are getting, because of the introduction of this fluctuation in the market at the time; is that not correct?

Mr. LIVINGSTON. Well, it is correct within the limits of the statement. When you buy a closed-end fund that is selling at a discount—let's take, for example, Tri-Continental Corp. which was selling at a discount——

Mr. KEITH. Were you looking over my shoulder?

Mr. LIVINGSTON. No, I was not, and if you bought Tri-Continental you did very well, if you held it long enough, because about 3 or 4 months ago it was selling around 22 or 23.

Mr. KEITH. I held it until my daughter's tuition came around again.

Mr. LIVINGSTON. Well, one should never buy stocks for tuition. But if you had purchased it 4 or 5 months ago, you would have bought it at a discount of 30 percent. The price of the stock would have been about 22 or 23. The market has not gone up very much in the meantime. Tri-Continental is now selling around 29, and the discount has fallen to 20 percent. So actually, people have begun, at least so far as Tri-Continental is concern, to think that this is a good security.

Now, what you get when you buy a closed-end mutual fund is not a guarantee that you will be able to sell the stock at the net asset value of the stocks and bonds and cash behind the shares. What you do get, however, is a bundle of assets 20 to 30 percent more than you are paying for, and these go to work for you. If you bought Tri-Continental today, you would get about $130 of assets for every hundred you put up.

Mr. KEITH. But aren't you in a sense really speculating as to what the demand will be?

Mr. LIVINGSTON. No, sir, I am not. Hear me out, please. What I am saying is that if you have $130 working for you, and the fund earns 3 percent on its money, it means that you are getting 30 percent more at 3 percent than if you had brought a no-load mutual fund where you would buy only $100 of assets for your money, and you are getting a good deal more than if you bought a load mutual fund where instead of getting $100 for every hundred you put up, you only get $91 of assets working for you.

So what I am saying is that you are getting a tangible extra by purchasing this, and I am also saying that if Wall Street brokers did not have these two hats, and were not interested in commissions, they would be selling these closed-end mutual funds, and there would be no discounts. And I can give you a specific example on this case if you want me to.

Mr. KEITH. Well, it is a bit difficult for me to follow all of what you have said.

Mr. LIVINGSTON. Can I reexplain it?

Mr. KEITH. I think it isn't really serving our purpose. I would like to have you do so but not at this time because the record need not be developed on that score. But I would like to understand it better and perhaps I will take some of your advice as a result of my further education.

Now, it seems to me that you are pretty hard on the industry and the salesman in your concluding statement, where you have striken the word "scant" and have said "There is no justification whatever for charging a sales fee on an investment that is to be made in the future."

Mr. LIVINGSTON. That is right, I mean it. I deliberately changed the word. I didn't want to hedge. I don't believe in a contractual front-end load plan; no, sir.

Mr. KEITH. But they charge a sales fee on other than a front-end load.

Mr. LIVINGSTON. I am only talking about a front-end load contractual.

Mr. KEITH. Taken out of context, one would——

Mr. LIVINGSTON. I didn't mean it that way.

Mr. KEITH. Well, you know how the press is at taking politician's statements out of context.

Mr. LIVINGSTON. Well, I think it is the front-end load only. That is the only case in which you have a sales fee on a security to be purchased in the future.

Mr. KEITH. I said that with a smile. You were reading your notes there.

Mr. LIVINGSTON. Oh, I am sorry. I know we embellish statements.

Mr. KEITH. I did read all of your columns and I had read them when they originally appeared. I guess in summary you would conclude that we don't need this industry to the extent that we should encourage people to get out and sell it as hard as they have. That it doesn't really bring sufficient capital into our market to either serve the capital requirements of the Nation or the need of the little fellow to get a share in the equities of our great society. That is in essence your point of view, I trust.

Mr. LIVINGSTON. Well, I think I would modify that, sir. I would say that the mutual fund industry today has 4 million shareholders. It is very well known.

As the result of my articles I received something like 12,000 to 14,000 letters. Many of the letters said, "I never knew there was such a thing as a no-load mutual fund. Thank you for telling me. Thank you for your courage in writing this," and so forth.

Well, now, it seems to me that the industry is becoming widely known. You don't need to have the very high sales fee any longer to encourage salesmen to spread the mutual fund gospel. There is money to be made at 5 percent in this industry. It is a very, very adequate reward for selling securities. On the New York Stock Exchange the commissions are much less.

What I think might happen would be that the marginal salesman might be put out, but there is also money to be made in the management end of the business.

Mr. KEITH. Thank you very much.

Mr. LIVINGSTON. Thank you.

Mr. Moss. We look at this sales fee and I have been interested in noting that it not an unusual phenomenon that whenever we hear legislation we talk about the small fund, the small salesman with the small selling margin. The fear was expressed earlier today by our first witness in his item No. 4 that inevitably the followup to any change in existing law would be to create ever larger funds and sales organizations.

Well, if we look back retrospectively at almost any business, that is the inevitable course of any successful operation, isn't it? They tend to concentrate and grow and the smaller ones fall by the wayside. They use many devices in an effort to prevent that happening, but it has happened in virtually every type of business one can think of today, hasn't it?

Mr. LIVINGSTON. I think so.

Mr. Moss. Now, selling is a very interesting endeavor. I was a salesman before I was a politician.

Mr. LIVINGSTON. I sold books when I was in college.

Mr. Moss. I sold many things. And I was also a real estate broker. And so I have a very healthy respect for the role that the commission plays in selling, and I think that you have basically in any sales organization two groups, particularly if you have an attractive commission structure and a hard market. You have the highly professional salesman and he is really going to be successful regardless of anyone or anything. He is going to succeed. And then you have those that are attracted like flies to honey, by the size of the commission, the potential. They don't stay in long but they do come in, and there is always a new supply of them to back up the group. This is the group of sales personnel, not the professional, and the one that is probably more concerned with the immediate short-range interest of his family than the long-range wisdom of giving the best advice and building a solid basis for repeat business and for the relations between friends that sends business to a store; isn't that right?

Mr. LIVINGSTON. I think that is right.

Mr. Moss. And if a sales commission is too high, we have had nothing in this record that indicates that 9.3 is any more justified than 5, or for that matter than 3. We have had many expressions of opinion but we have had nothing in the record that I can see, and I have watched it very carefully, that shows that there is a greater justification for one or the other, except as you pointed out, and I think very properly, if we are only concerned with the sales organization.

The interest of this committee, the reason for the creation of the Securities and Exchange Commission, the very conditions which brought it about in the early 1930's was because the previous system did not adequately recognize the public or the investing public's interest, isn't that correct?

Mr. LIVINGSTON. I think that is right. I might add, Mr. Chairman, that there is something ot suggest that the 9.3-percent sales load is high, and that is that so many of these no-load mutual funds are growing and prospering. The T. Rowe Price Co. of Baltimore recently announced that they were no longer going to take any new shareholders in New Horizons Fund because it had reached the size that they felt was completely adequate to their responsibilities. If you look at the prospectus of Dreyfus Fund, which has been a very rapidly growing fund, and an extremely successful fund, it indicates that the sale of the fund had become so great that management had to consider changing their investment policy, because you can't operate with a billion dollars the way you could operate with $200 or $300 or $400 million. And I sometimes wonder if the sales effort hasn't begun to wag the dog in this industry.

There was a time, when this industry first began, that funds would discuss what was the optimum size, $300, $400, or $500 million. But now, as far as the load funds are concerned, this is out the window—bigger and bigger.

Mr. Moss. That of course gets to the point that Congressman Keith stressed, the need to study the problem of institutionalization of the markets. But the one point I wanted to bring into focus is that while we certainly are not expecting to act in a manner to the complete dis-

advantage or in utter disregard of the interests of the seller, salesmen, or the selling organization, our underlying responsibility is to the overall investing public, and if he is encouraged to continue investing, it follows inevitably that the business itself will be——

Mr. LIVINGSTON. I think that is right.

Mr. MOSS. I want to thank you very much. Oh, Mr. Keith has a couple more questions.

Mr. KEITH. Have you by chance done a column on the monthly investment plan? Have you done a column on that?

Mr. LIVINGSTON. I don't believe I have.

Mr. KEITH. Would you care to comment as to this?

Mr. LIVINGSTON. Well, it has always seemed to me a cumbersome plan. When it first came out I thought it was cumbersome, and if I were an investor and I had a choice, I would certainly buy a no-load mutual fund and get a diversified group of stocks rather than to try to pick up a part of a share of U.S. Steel or A.T. & T. or one or two shares every 2 or 3 months.

Mr. KEITH. I am sure you have done many columns on speculation.

Mr. LIVINGSTON. You mean on the go-go funds and this new attitude toward investing?

Mr. KEITH. Not necessarily the go-go funds, but the institutionalization of the market and the tendency where there is a narrow market for institutional investors—by the way, I think I saw where commercial banks in a study by the New York Stock Exchange did more trading of a speculative nature than did mutual funds. I believe that the net position at the end of the period indicated that commercial banks had been more active in this kind of activity than others.

Mr. LIVINGSTON. Well, yes, I have written about this, but not with any firm conviction as to its impact upon the market, because there are no quantitative figures. I know that the U.S. Trust Co., which is one of the most venerated and staid institutions, has now announced a policy of "Best by Test." You have to show performance in order to keep your customers and get new customers. And there seems to be a tendency to emphasize short-run returns from investing rather than what you expect to get 2, 3, or 5 years from now. And I suspect that this is all part of the environment in which we live, in which people are trading in securities for dollars and dollars and dollars, and this is what John Maynard Keynes talked about in his chapter on "Long-Term Expectation in the 'General Theory.'"

Mr. KEITH. On this question of commercial banks and institutions and their activities in the market, the average charter of a commercial bank indicates I believe that its purpose is to serve the community in its efforts to finance corporate activities. Is that about correct?

Mr. LIVINGSTON. Yes, sir.

Mr. KEITH. Now do you think there is any tendency for commercial banks now to move their surplus and perhaps their reserves in the market in a way to make more money for their bank and its shareholders in an activity which has been thus far secondary?

Mr. LIVINGSTON. Well, I think we are talking about two different things, sir.

Mr. KEITH. We are talking about institutional——

Mr. LIVINGSTON. I was talking about the trust department of the bank.

Mr. KEITH. Yes.

Mr. LIVINGSTON. Handling the funds of clients.

Mr. KEITH. And my question goes beyond that.

Mr. LIVINGSTON. I don't think the banks are permitted to invest any of their own money to any large extent in stocks, so that to that extent——

Mr. KEITH. Do you think that these investments I have referred to in the New York Stock Exchange report on this subject with commercial banks are listed as being big buyers and sellers, do you think that those were the trust accounts?

Mr. LIVINGSTON. Oh, sure, I think they were pension funds. Oh, yes, pension funds that the banks handle, and individual trust accounts. Oh, I don't think, oh, no, they weren't the banks' funds. I think the banks would like to get into it, but they are forbidden by law to do so.

Mr. KEITH. Well, the banks there are fiduciaries, this is what you point out, in the literal sense of the word.

Mr. LIVINGSTON. Yes, but they have a carte blanche in most fiduciary accounts to invest as they please, and they have to render service to the person who is the investor, or the account may be shifted to somewhere else.

Mr. KEITH. Do you think that there is any real threat of increases in institutional activities that is of such speculative nature as to adversely affect the public interest?

Mr. LIVINGSTON. Well, I do indeed. I think that the fear of what is going to happen to the dollar, the concern about inflation is such that insurance companies and pension funds and even large individual investors who would normally put their money in bonds are putting it in common stocks. This is creating a notion that you can make money in the stock market. I know from the letters I have received and the desire of people to get into funds that are going to perform well. It is always a desire to protect themselves against deterioration in the dollar, or to speculate to get something for nothing.

Mr. KEITH. Well, they expect to get their share in the equities of the corporate assets of this country, but I am not talking about an informed trustee or pension fund manager considering the long-range interests, as a trustee. I am just wondering, you mentioned the go-go funds, the performance funds, I just say that that is a part of the whole thing. That banks, insurance companies, and private investors move into the market in a big way where it is a narrow market, and by that move affect the price of the stock, and then move out in a way that allows them to make a profit on that transaction, and perhaps leaves others stranded. Do you follow me?

Mr. LIVINGSTON. Yes, I do.

Mr. KEITH. Do you think that there is any need for investigation by the SEC or the Congress or both into this kind of activity? Do you think it requires our serious attention?

Mr. LIVINGSTON. I wouldn't know. I think only an investigation would reveal whether it is a powerful enough influence on the market.

Obviously there is great temptation. In the 1920's the pools would buy stocks and push them up, and then sell them out. They were frequently at the mercy of the market itself, because they didn't have unlimited funds.

Now you get the large investment companies that decide to purchase a particular stock, and they begin accumulating it. They push it up, push it up and up. And then they figure that the price is about right and it is ripe for selling and then they sell. They walk away from it; they sell it out. I don't know whether there is anything wrong in that.

Now if you find that there is a deliberate manipulation, somebody says there is a short supply in this and I am going to push it up and then get out, fine. I don't know, I would hesitate to suggest that it is as calculated as that, that it happens.

You see, the U.S. Trust Co. has a policy on this. They have graded investments as A, B, and C. I have forgotten just what the categorization is. But they would say A is a stock which is low, let's buy it at such and such a price. B is a stock that we want to own, but it is above a proper price and maybe we had better not buy it now. And C is a stock which we would like to have in our long-term portfolio, but it is too high, we won't buy it.

Well, now they are constantly moving stocks fom A to B to C, depending upon the price. Well, suppose you buy a stock at A, which is a stock it wants in its portfolio for long-term holding. And so they begin putting it into the accounts that they have, and it begins moving up. When it reaches B, they will continue to hold it in the accounts that have it, but they won't buy it for future accounts. Then when it gets up to C, they decide to sell it, because it is no longer attractive in terms of price.

Well, could anybody suggest that that is speculation, deliberately pushing up stock? Now if this becomes uniform policy within Wall Street, if this is a practice of many trust companies and many institutions and various funds, then you are going to get the problem that they will all be grading many of these stocks in the same way, and one of these days they are going to put them all or a great many of them in the C category and they will just try to walk away from them and there will be no market. This is what happened in 1929. This is always what happens in pool operations.

It is one of the great problems where people are always anticipating what other people will anticipate prices ought to be. I suggest you read this chapter in Keynes, on long-term expectations.

Mr. KEITH. I would like to but my constituents have more pressing needs that keep me from it, but I may have to get to it.

One last question. Many witnesses have been talking about the economies of size.

Mr. LIVINGSTON. Of scale; yes.

Mr. KEITH. That is a phrase that has come up. Do you feel that a large bank like U.S. Trust should on behalf of its accounts turn to the third market rather than buying on the exchanges, to give them the advantages of economies of size?

Mr. LIVINGSTON. I think a large bank has a responsibility, a fiduciary responsibility of getting the stock at the best price for its clients, and I think if it can get it in the third market it is its responsibility so to do.

Mr. KEITH. I have no more questions, Mr. Chairman.

Mr. MOSS. I want to thank you. Regretfully, the second bell has just rung and it is necessary that we go to the floor. The committee will adjourn until tomorrow morning at 10 o'clock.

(Whereupon, at 12:45 p.m., the subcommittee adjourned, to reconvene Tuesday, October 24, 1967, at 10 a.m.)

INVESTMENT COMPANY ACT AMENDMENTS OF 1967

TUESDAY, OCTOBER 24, 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.

Before hearing our first witness, I would like to ask unanimous consent that the record be held open for the balance of this week to receive statements from those who desire to submit them to the subcommittee. Hearing no objection, that will be the order of the committee.

Our witness this morning is the Honorable Manuel F. Cohen, Chairman of the Securities and Exchange Commission, who is returning for the purposes of summarizing the views of the Commission after some 2 weeks of testimony before this subcommittee by representatives of all segments of the industry. Mr. Cohen.

STATEMENT OF HON. MANUEL F. COHEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY PHILIP LOOMIS, GENERAL COUNSEL—Resumed

Mr. COHEN. Good morning, Mr. Chairman, and Mr. Watkins.

Mr. WATKINS. Good morning.

Mr. COHEN. I guess I should at the outset repeat what the reporter asked me this morning. He said, "Mr. Cohen, will you read your 44-page statement or summarize it in 80 pages?" I am afraid I am going to do the latter. But seriously, I will try to be as brief as possible, so that I can take as many of your questions as your time permits. I am available at any time.

As I say, I am very pleased to be here to answer some of the objections that have been made and to clear up certain of the misconceptions that may have been created by testimony of certain representatives of the industry.

At the outset I should emphasize that when I was here about 2 weeks ago I told you that the purpose of this bill was a rather simple one, and that was to provide a fair shake to the millions of Americans who have invested in mutual funds and other types of investment companies, and for the uncounted additional millions who will invest in this medium in the future.

85-592—68—pt. 2——17

I do want to emphasize, reemphasize, that that is the basic purpose and the sole purpose of this statute. However, when I say sole purpose, I do want to indicate that it has a corollary effect, and it is an effect that may be found in all of the statutes administered by the Commission. Those statutes I think were deliberately designed and have had the effect of protecting the securities industry itself from the consequences of the overreaching by some who have been engaged in that business.

I cannot recall a single advance made in the securities laws which has not been met with the argument that it would have the effect of making business less profitable or even impossible for some segment of the industry or for some people. I need not repeat, I am sure all of you recall, that the first of the statutes, all of which have their genesis in this committee and are monuments to the wisdom of the members of this committee through the years, was the Securities Act of 1933, and that was greeted with the argument that grass would grow in Wall Street. And every improvement in the statutes and every improvement in the rules has always been met with a similar argument, that any such change would upset the market, would create problems for those engaged in the market and for the people that they serve.

But I think the facts of the matter are that after all of these improvements, we have a securities business that is bigger, that is stronger, healthier and more prosperous than it has ever been before in the history of this country, and indeed in the history of the world, and as I will show later, this is especially true for those engaged in the business of organizing, managing, and selling the shares of mutual funds.

Now it is true that the securities industry is a closely regulated industry, and it has been closely regulated by the Federal Government and by the self-regulatory organizations created by statutes passed by the Congress for more than a third of a century, and I cannot overemphasize that the legislation before you really breaks no new grounds. It is not a tampering with the free enterprise system. It is merely a few relatively minor, although some would think otherwise, adjustments in an existing regulatory pattern that was carefully hammered out before this committe and the Congress.

The reasons for the changes grow from the great affluence that has affected this industry in the 27 years since the 1940 act was passed. I should say that Congress' concern with investment companies precedes that time by a substantial period.

The 1933 act, as you will recall, requires disclosure in connection with any offering of securities by an issuer, or on its behalf. But in 1935, the Congress felt that disclosure was not adequate to meet the problems that existed in what was then a fledgling and infant industry, and in the statute passed in that year directed the Commission to conduct a comprehensive study of the industry. This led to a substantial number of reports to the Congress and finally in 1940 the Congress passed the Investment Company Act and, I should make clear, without a single dissenting vote in the Congress. The report of this committee makes clear, it states unequivocally, that disclosure is an inadequate method for dealing with the problems that arise in this industry, problems which arise in some measure because of the extraordinary structure of this industry.

Now a great deal has been said in the last couple of weeks about competition in this business. I think the plain fact of the matter is that the business does have a substantial number of units, but very little competition in the sense in which that term is ordinarily used. This may sound like a paradox but it isn't. There are a great many of these separate units, but they are severely restricted by law, Federal law, from competing with one another by offering better prices for the securities of a particular fund.

There is no effort—and I introduced in evidence, when I appeared here before, a document which indicates that the trend is continuing—there is no effort to offer a better deal to the investor by providing a lesser charge. The competition, to the extent that it exists, is to seek the favor of the salesman, and his employer, the dealer, and that is achieved and is still in progress by offering greater financial rewards to those who engage in the sale of shares.

Now, this type of competition bears little relationship, if any, to free enterprise, the classical free enterprise system as we know it, and the type of competition that we discuss. It is for this reason that I have earlier referred to this as a perverse form of competition. It is the kind of competition which has Government protection and encouragement for charging the highest charges that the traffic will bear.

It is a system under which the Federal Government authorizes the industry to operate outside the controls of the antitrust law, outside the controls normally provided by disclosure of compensation for management services, and outside the controls provided normally by competitive free enterprise. In fact, the statute provides a shield against those forces from operating within this industry. It is for this reason, I believe, that the Federal Government and the industry share responsibility for the excessive charges now being made to the American public for investment in mutual funds, and it is for this reason that I think the Federal Government has, and I would hope that the industry would join in meeting, the responsibility to give adequate weight to the interests of the public, and thus assuring the continued health and development of the securities markets, and more particularly of these mutual funds.

I wish to emphasize that this bill is not directed against mutual funds. In our view this bill will not affect mutual funds. It is designed to make mutual funds a more attractive vehicle for investors, many of whom perhaps were deflected from taking advantage of this vehicle, because of the high acquisition and maintenance costs.

Now, perhaps I should deal with advisory fees. In this area, in my view, industry witnesses have completely misconstrued what our proposal is, why we advanced it, and how it would operate. Industry witnesses conceded (1) that they were fiduciaries, (2) that investment advisory fees should be reasonable, and (3) just to quote their words, "the investment adviser has a definite responsibility to see to it that the fees are reasonable."

Although they were at times, some of them anyway, rather coy about admitting this fiduciary responsibility, after some searching questions put by the subcommittee, the record is indubitably clear on this subject.

Mr. WATKINS. Mr. Chairman.

Mr. COHEN. Yes, sir.

Mr. WATKINS. Mr. Cohen, do you mind giving me the page you are on?

Mr. COHEN. I am reading from some notes——

Mr. WATKINS. I thought so.

Mr. COHEN (continuing). That I prepared, Mr. Watkins. As I said, I was going to——

Mr. WATKINS. All right, you go ahead. If you get back to your script let me know. Are you going to read your script?

Mr. COHEN. No, sir. I offer the script for the record, but when I have completed this I would be more than happy, subject to the chairman's wishes, to take any questions you may wish to put to me.

Mr. WATKINS. But you are not using your record now. You are speaking off the cuff.

Mr. COHEN. I am using some notes. It is intended to summarize the situation, perhaps to highlight some of the more important issues as I see them.

Mr. WATKINS. You go right ahead. I was just lost here. I couldn't find it in the script.

Mr. COHEN. I am sorry, sir.

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

The investment adviser does control the fund. But nowhere have they been willing to mention, even under the rather penetrating questions put by the subcommittee, what is a necessary consequence of the situation that they concede as well as an important fact of life in this business, and that is that the investment adviser in effect sets the fee, and he does so in a situation in which he has a very definite conflict of interest. In fact, this point was emphasized by a number of witnesses, some of whom referred to the fact that the investment advisory organization was a corporation which had shareholders, and that obviously, though perhaps they didn't put it exactly this way, their shareholders are interested in maximizing the profits that they may gain from the service that they provide to the investment company.

I can't think of a more classic case of a conflict of interest, and a stronger case of two groups pulling in opposite directions, and yet the person who sits in that position sits at the head of the table and he sits at the foot of the table, and he sits all around the table.

In this connection I think I should reemphasize that, with one exception that I recall, no one suggested that the directors are really in a position to negotiate, as that term is normally understood, in the fixing of fees. In fact, there were some witnesses, including some who sit on the boards of investment companies, who suggested that that was not the purpose for which they were chosen. One, who I believe is a practicing lawyer as well as a member of the board, suggested it would be inconsistent with his obligation as a director to attempt, in any way, to upset the relationship between the adviser and the fund in any such bargaining arrangement. Now, unless, of course, there is the possibility that the board might change the arrangement, I have great difficulty in seeing how any type of effective or even ineffective bargaining can take place.

But it is by a studious disregard of this situation that the industry is able to misconstrue our proposal as involving ratemaking or profit regulation. It is nothing of the sort. However, since——

Mr. Moss. Mr. Chairman, Mr. Keith has a question.

Mr. COHEN. Yes, sir.

Mr. KEITH. You seem to be reading from a prepared statement.

Mr. COHEN. I am reading from some notes of mine of various types and kinds.

Mr. KEITH. I am somewhat handicapped. We had hoped to have your rebuttal statement yesterday so that we could review it and have a chance to comment on it. I am trying to read what you have prepared here and listen to what you are saying there, and it is difficult to follow. But I would like to have you restate if you could what you have said in the last couple of minutes. You seem to be saying that this is a strange phenomenon that exists on the part of the companies with the usual corporate structure and operation, what you might call corporate democracy. I wish you would restate what you have said.

Mr. COHEN. Some of the things are not included in the paper I have before me but I will try.

Mr. KEITH. Perhaps if the reporter would go back 2 or 3 minutes and read to us what you have got there in your notes, please.

Mr. COHEN. I would prefer to restate it, Mr. Keith, because I will make it stronger this time, but I will be glad to take your suggestion.

Mr. KEITH. You might pinpoint what I think is after all the main difference of opinion in one of the two areas involved.

Mr. COHEN. I don't think that so far as the things I have just said that there is any difference of opinion. I have heard no witness deny the fact that he is really a fiduciary. I have heard no witness say that the fee should not be reasonable. I have heard no witness say that he does not have an obligation to see that the fee is reasonable. I have only heard one witness suggest that there is truly effective argument, I am leaving the word "bargaining" out deliberately, with respect to fees. I don't think there is any great dispute here.

Mr. KEITH. I am talking about the corporate entity involved here, the way in which it differs from the usual corporate structure.

Mr. COHEN. I didn't testify to that, but I will be glad to right now.

Mr. KEITH. It seemed to me that you were speaking to this, even though it may not have surfaced, and you recall in your first statement you talked about how, as I recall it, the management companies formed the mutual funds, and then in a later application or further delineation of the activities of the mutual funds, you mentioned that they entered into a contract with the management group, and indicated that the tail thus was wagging the dog.

Now is it not a fact that by and large these investment companies have chosen a mutual fund vehicle to sell their product, and that there is a corporate purpose being served by this close relationship, and that it is simply the vehicle which is used to merchandise mutual funds to the mutual benefit of the person who buys it and the management company who advises?

Mr. COHEN. No, sir.

Mr. KEITH. You don't feel that this is the historical and in effect present modus operandi?

Mr. COHEN. Well, you have two questions in that, two points you make in that question. It is true, as I stated before, that a number of funds were created by investment counselors in order to take care of persons who did not have the amount of cash available that they thought appropriate for handling that person's problems or plans on an individual basis. They therefore set about to create a corporation in which the individual's wishes would not have to be dealt with, but they created an institution whereby some person could come in and obtain a participation in the institution, without any choice on his part, once he is in there, as to the nature of the securities, as to the management activities of the company. But while this is true of certain investment counselors——

Mr. KEITH. Pardon me. I just want to keep it straight as you go along here. At the time that he entered into this contract to acquire the shares in the mutual fund, the management company portfolio, he was advised as to what the financial objectives were, the investment policy. I mean if there was none stated, then it was carte blanche, but generally speaking it would give some indication in the prospectus to comply with customer rules and procedures in this area.

Mr. COHEN. Mr. Keith, I must disagree with that about 1,000 percent. First, I want to complete the answer to your question. While there were a number of investment counselors who set up funds for this purpose, I did indicate when I was here last that a great many other funds were created by broker-dealers, in order to have a vehicle that would be available and also perhaps to partake of the brokerage. It is interesting to note that a great many of these investment counselors who did set up these organizations set up an organization which would provide its shares to the general public at no load, no charge, and I think you heard from representatives of that group.

In addition to that, mutual funds were set up by business people, some of whom had no experience whatsoever in this field at all, because this as I indicated has provided for those who have created these things, sold them, managed them, something in the nature of a money tree, and this is found to be the fact today.

There is a rubber company, at least one, that owns a management firm; I.T. & T. owns one. There is a brewery company. It is just good business. In fact, many of them are so incapable of running the fund that they subcontract it out, and I introduced as an exhibit tables which showed that where that existed and where there was arm's length bargaining for the provision of the services, the charges made to the investment adviser, who is receiving the typical charge, were very very substantially less than that. I think I have an extra copy of that exhibit here today, and I can illustrate that at some length.

But now coming back to your question as to the structure, it seems to me that at various times the industry goes one way and says, "Why, this is a corporation, and if we are to be tested in what we do, we must rely on the traditional corporate waste doctrine to protect us from everything."

At another time they say, "Well, that is just in the way somehow, and this is really a shell, and it is a direct relationship."

Well, it isn't a direct relationship. It is a corporation. It is deliberately chosen as such, and the Congress recognized that in 1940, and because it is a corporation and because it is an institution, you get institutionalized services. I think it should be viewed that way.

Now this was created to provide a mutual organization. That is not the technical term. But it is far from a mutual organization; there has been no fair sharing of the growth of these mutual organizations. And I will show you later, only because the industry introduced some figures which I think are completely misleading, what the actual facts are with respect to these mutual organizations. But I think it is important to emphasize——

Mr. KEITH. Are you implying that it is a mutual organization?

Mr. COHEN. I am saying that it is sold as a mutual fund.

Mr. KEITH. Yes.

Mr. COHEN. And they have tried to argue that it is a mutual organization.

Mr. KEITH. Who is trying to argue that?

Mr. COHEN. Well, if you——

Mr. KEITH. I raise that question because they were very careful it seemed to me not to claim that they were mutual.

Mr. COHEN. Because they are on the horns of a dilemma. On the one hand they want to say this is a personal service.

Mr. KEITH. Who argued that it was a mutual in the legal or income tax sense which is a significant factor? They were very careful it seemed to me to compare their operations with that of a stock life insurance company.

Mr. COHEN. I want to deal with that and I brought some figures along to deal with that.

Mr. KEITH. My second question to you, I am not quite happy with your first answer——

Mr. COHEN. I know, but if you will let me answer them one at a time, Mr. Keith, as I forget them.

Mr. KEITH. Will you respond to that point?

Mr. COHEN. Yes, sir. So far as this mutualization that we are talking about, these are referred to as mutual funds. That is the common parlance. The statute refers to them largely as open end companies. Now what I mean is that there is a continual argument "Look what this fellow is getting. He is getting this great service and it costs him $22 a year," as if that is——

Mr. KEITH. My question was who has argued that they were mutual in the legal or income tax point of view.

Mr. COHEN. I don't know about the income tax thing. I have not heard any arguments about that.

Mr. KEITH. Or the legal.

Mr. COHEN. What I am saying, Mr. Keith, I am trying to answer your question——

Mr. KEITH. My question is, the one that I want you to answer is, who has argued that they were mutual in fact as well as in name?

Mr. COHEN. They don't argue it that way, but by arguing to you that this is really a relationship between the investment adviser and the individual shareholder, who may be just a name that is somewhere in a computer, they are arguing that this is that type of an arrangement, and that is the type of discussion that goes on.

Mr. KEITH. They are arguing that it is a corporate arrangement as contrasted to a mutual arrangement.

Mr. COHEN. It is a corporate arrangement when their actions are asked to be put into account. Then they like to rely on the corporate waste doctrine.

Mr. STUCKEY. Will the gentleman yield?

Mr. COHEN. Whereas if this was direct relationship of someone providing the service, I mean it would be very difficult for them not to concede that they weren't in fact trustees, but they are not prepared to accept that, although they do admit they are fiduciaries.

Mr. KEITH. Mr. Stuckey has a question. I yield.

Mr. STUCKEY. We are talking about corporate structure and we talked about the investment advisory fees. If it is in fact a corporate structure, then if the majority voted against renewing the contract then it would not be renewed; is that right?

Mr. COHEN. It has never happened, sir.

Mr. STUCKEY. But in fact they could vote not to renew it, is that correct?

Mr. COHEN. That is right, Mr. Stuckey, it could happen; yes, sir. May I finish the answer though?

Mr. STUCKEY. I think you just did.

Mr. COHEN. I don't think I have.

Mr. STUCKEY. You just said that they could vote not to renew it.

Mr. COHEN. Theoretically, yes, sir.

Mr. STUCKEY. So then it would be in a sense a corporate structure. Now what would be the difference between that say that I owned 51 percent of a company and I could vote all the directors that I wanted to own there. Would that be a conflict of interest?

Mr. COHEN. Would you have a conflict of interest? If you engaged in a transaction with your company there would be a conflict of interest and the law might hold you to account.

Mr. STUCKEY. In other words, if I had a contract with the corporation.

Mr. COHEN. That is exactly right.

Mr. STUCKEY. There would be a conflict of interest.

Mr. COHEN. There would be a conflict of interest and the courts and the law have recognized this situation for many years. And if someone wanted to question the reasonableness, the fairness of that transaction, he could do so.

Mr. STUCKEY. Sure, that is right, a minority stockholder could question it. So they could also do the same thing through the courts.

Mr. COHEN. No, they can't, sir.

Mr. STUCKEY. If a majority voted in favor of renewal which is disclosed in the proxy statement then there is full disclosure. If they wanted to vote not to renew it then they could also do that.

Mr. COHEN. Let me answer that. I think you had the testimony of a prominent judge here, who indicated that were it not for these provisions in the statute, which the Congress put in in 1940 as a protection to investors, that is to say stockholder ratification and unaffiliated director approval, that these things could be put into account. But because of those facts, the courts have construed the situation as not making it possible for them to test the arrangement, the contract, on the basis of reasonableness, but to use his language, the plaintiff has to prove that it is excessively excessive or unreasonably unreasonable.

Now that is the difference between the ordinary corporate structure and this one.

Mr. Moss. The Chairman has correctly used the statement of the judge, excessively excessive would be the burden of proof which would be put on anyone in this connection.

Mr. STUCKEY. Is this the way the law reads?

Mr. COHEN. This is what the courts have said.

Mr. MOSS. The judge said it as a means of emphasizing the very different nature of proof which would be undertaken.

Mr. STUCKEY. Now let's go back to the conflict of interest because this concerns me and let's go back to saying that I own 51 percent of a corporation. Then the corporation gave me a contract as president and chairman of the board. This would be a conflict of interest.

Mr. COHEN. Would that be a conflict?

Mr. STUCKEY. Yes.

Mr. COHEN. Yes, indeed.

Mr. STUCKEY. We have got a lot to——

Mr. COHEN. There are a few cases in recent years, Mr. Stuckey, that never reached the courts. One of the very largest oil companies in America entered into a contract with a director and with his firm. When that was disclosed, he resigned as a director. There was another situation where the president of a very large insurance company, who was a director of a prominent company engaged in a transaction with his company, and I am not altogether sure there was anything wrong with the situation, but when that was disclosed, he resigned as president of the insurance company.

There was another situation where a gentleman was the president of a large automobile company, and I am just talking about a few cases that have been in the newspapers in the last several years, where his company, his automobile company entered into contracts with certain supplier companies in which he had an interest. When that was disclosed, he was compelled to resign.

I am not speaking only to basic business morality, forgetting the law. So far as the law is concerned, it is absolutely clear that where there is this situation, and I referred to the *Geddes* v. *Anaconda* case when I was here last, where that type of transaction is put in issue the defendant whether he owns 51 or 91 percent has the burden of establishing the fairness of it. In our proposal we don't go quite that far.

Mr. STUCKEY. But simply because he owns 51 percent and does hold the contract does not make him in violation of the law.

Mr. COHEN. No, but you asked me whether he was in a conflict of interest and I have to say the answer is right. But once being in the conflict of interest, that transaction, even though entered into by the board, is subject to some examinaiton by an independent body.

Mr. STUCKEY. Sure, this is the way that our system works. But you are saying that this is a conflict of interest. How many corporations would you say in this country, just venturing a guess, where a person owns 51 percent or more and is in fact president of the corporation or chairman of the board?

Mr. COHEN. Well, I think there are probably a great many of them, but I don't know that they all engage——

Mr. STUCKEY. Aren't they in violation of the law?

Mr. COHEN. No, sir; I didn't say that the ownership of the stock was a violation of law nor did I say engaging in a transaction was a violation of law. The only point I am making is that when they do in fact engage in a transaction of that kind, they are in the position of conflict of interest, and under the laws of the United States and of the States, this may be brought into question.

Mr. STUCKEY. That is right, but they still are not actually in violation of the law.

Mr. COHEN. I didn't say they were, sir. If I suggested that, then perhaps I overstated it.

Mr. STUCKEY. All right. So if this is true in a regular corporate structure then the same thing would be true in——

Mr. COHEN. No, sir. I think the judge explained it much better than I, in fact he sat on a couple of cases that dealt with this subject. The courts have a rule which they apply in this case. Where you have, as required by statute, and as put in by the Congress to protect the investors, two things, shareholder ratification and approval by the directors, both or singly, the courts say that the ordinary test of whether or not there has been overreaching or just unreasonableness has to be put aside, and the plaintiff has the burden of proving corporate waste, which the judge described as being excessively excessive or unreasonably unreasonable.

Now it is surprising to me that these people, who admit that they are fiduciaries, who do not deny that they are in a conflict of interest, and they don't deny this at all nor do they deny, in fact some of them say as a matter of course, that they run these funds, they are their funds, it is almost as if they have a proprietary interest, would urge before this committee that they should not be subject to any independent review by any independent body. It is an extraordinary situation.

Mr. STUCKEY. The point that I was trying to make here, because even though an investment adviser does sit on the board and he is a stockholder, this in itself does not constitute a conflict of interest.

Mr. COHEN. The investment adviser is rarely a stockholder. In fact, I know of very few situations if any where the investment adviser is a stockholder of the fund. Normally he is not.

Mr. STUCKEY. I can think of corporations where members of the board sit on the board and are not necessarily a stockholder.

Mr. COHEN. This is true, but I was trying to answer your question factually. They do have this contract. There is no denying the factual situation.

Mr. STUCKEY. The point I am trying to get across is whether it is a corporation, and the mutual funds as I understand it are a corporation. I do not see the difference between the mutuals and the regular corporation because if a majority votes against renewal then you simply do not renew the contract, and I still maintain that this is legally so, that this can be done, and you yourself agree.

Mr. COHEN. Let me try this another way, Mr. Stuckey. I think you asked me, and I think Mr. Keith asked me whether or not all of these things weren't disclosed. Well, the fact of the matter is that these companies were operating in 1933 and before 1933, and in 1933 the act was passed requiring disclosure. So immediately in 1933 all of these things had to be disclosed. But the Congress determined in 1935 that that was not enough, and it directed the Commission to conduct a comprehensive study, which resulted in I think five or six volumes of reports, and ultimately in 1940 at the request of the industry as well as that of the Commission, a statute was passed, and this committee I said in its report to the Congress that disclosure cannot deal with the problem. And insofar as the problem we are talking about is con-

cerned, it was urged to this committee that these were small companies, they would never grow very large.

The Congress therefore felt that certain elementary safeguards should be put into the statute, and these were to provide in certain situations that a minority of the board would be unaffiliated and in others a majority, and that the unaffiliated directors would have the job of approving the contract. They also provided for shareholder ratification.

What I am trying to say is that if you didn't have these requirements, the courts might have been able to deal with these problems under the same rules against overreaching that apply with respect to ordinary corporations But because of those things, the courts have said that those rules shall not apply. The plaintiff must prove corporate waste, and that is the end of the world, so to speak.

Mr. STUCKEY. So he can do this.

Mr. COHEN. Sorry?

Mr. STUCKEY. So he can do this. So an average stockholder can do this, right, through the vote.

Mr. COHEN. He has to carry the burden of proof, and no stockholder has been able to do that.

Mr. STUCKEY. And this is what I——

Mr. COHEN. Even though in 50 cases this was brought in issue.

Mr. STUCKEY. All of these people that we refer to, and I will be quite honest with you, I have heard no public outcry from them. You haven't seen that many cases, and I am sure if this was this much of a gross excess, of excessively excessive wrong with it, we would have heard this public outcry because people simply do not like to be taken advantage of.

Personnally I agree with what you said up to and including the 1940 act. I think it has worked quite well. It does give them legal means if they have a group or if they are being mistreated.

Mr. COHEN. I don't know if you are agreeing with what I said, but I understand your point, Mr. Stuckey.

Now so far as the public outcry is concerned, there are a number of answers to that. I don't know about your mail, but mine has been very substantial. And I think that there have been other things that have been in the public print which deal with this particular problem. But I don't think you measure this by the numbers of people, some of them small, modest people who have jobs, that go about their own business, by counting the letters that they write. Even if you did that, I have got a lot of letters. That is not the point. The basic point is that the Congress created a structure here. The Federal Government is responsible for it. It has produced the result which the Commission, after studying this matter very, very carefully over a long period of time, has found to be unfair to the shareholders, and all we are suggesting here is not any radical change of the laws, not any new radical statute, but a minor, a relatively minor, adjustment of the existing statute to take care of a problem which it was urged on the Congress would not arise in 1940. It has now arisen.

Mr. STUCKEY. How can you say that it would not put them out of the business in this situation?

Mr. COHEN. We wouldn't put any mutual fund out of a business and I don't know how you arrive at the conclusion that you would put half of the businesses out of business. I just don't get it.

Mr. Moss. The Chair notes the desires of the members and he shares the desire to have the utmost discussion, but in view of the statement when the witness has concluded, if we are ever going to bring these hearings to a conclusion, we will hold to a 5-minute rule. With the utmost regret, we have now taken 40 minutes to discuss two relatively unimportant items in a statement which runs to approximately 40 pages.

Mr. KEITH. Mr. Chairman.

Mr. Moss. Mr. Keith.

Mr. KEITH. I have no objections to your ruling, but I would not like to let the record stand that this is relatively an unimportant item.

Mr. Moss. The Chair of course in making that statement merely voices his own opinion, and does not attempt to have the record bear the burden of conveying the idea that it is a consensus of the committee.

Mr. KEITH. Thank you.

Mr. COHEN. Mr. Chairman, I don't want to violate your ruling: I appreciate it very much. But if I may, I would like to say one further thing in answer to the questions that Mr. Stuckey has put to me, and implicit in some of the other questions put to me.

When the industry was here, they introduced, I think in connection with the testimony of Mr. Welch, certain tables which were designed to show the percentage of net earnings as compared with the assets in three categories: banks, insurance companies, and mutual funds. They had a list of 25 of the largest stock life insurance companies, 25 of the largest banks, and a list of mutual fund assets and earnings of management companies in 1966, in which they attempted to show that comparing assets under management, the mutual fund managers' net earnings were relatively modest.

Now we did not raise this issue about profits. We think, however, that since they brought it in we owe it to the committee to present the situation as it exists, and as the facts demonstrate. It is an unusual situation to indicate their profitability in relationship to assets of the funds.

I think the normal way people consider this is by considering the relationship of earnings to stockholders' equity or to gross revenues, and I have some tables here which I wish to submit to the committee, and I will make them available for anybody at the head of the table, which takes the same banks, the same insurance companies and the same group of management companies, those as to which we have information—these management companies are companies which do nothing but manage investment companies—to show the difference in the situation.

Now, whereas, in the case of the management companies, the group we have selected shows earnings as a percentage of stockholders' equity running say from approximately 34 to 72 percent, in the case of stock life insurance companies there is only one situation, three situations, I am sorry, that exceed 15 percent, and in the case of the 25 largest banks, there isn't one situation that reaches as much as 14 percent.

Now we also have a table which shows the profit margin before taxes in relation to total income of these management companies. With one exception, which is Channing Financial Corp., whose ex-

perience has not been good, they range from approximately 20 percent to approximately 61 percent of gross revenue.

Now those are the figures, I think, which analysts and which anyone interested in determining the success or lack of success, the profitability or lack of it, of a particular organization, use, and I am very happy to submit those for the benefit of the committee. As I say, we have additional copies we will leave at the head of the table for anyone else that cares to examine them.

(The tables referred to follow:)

INCOME EXPENSES AND PROFITS BEFORE FEDERAL INCOME TAXES OF MUTUAL FUND ADVISORY ORGANIZATIONS FOR THEIR FISCAL YEAR ENDED 1966

[Dollar amounts in thousands]

	Fiscal year ended	Advisory fees received	Net distribution income [1]	Other income	Total income	Before Federal taxes	
						Profit (loss)	Profit margin (percent)
Channing Financial Corp	Dec. 31	$4,351	$2,460	$343	[2] $7,154	$7	0.1
Distributors Group, Inc	do	1,468	397	32	[3] 1,897	453	23.9
The Dreyfus Corp	do	7,498	3,245	799	11,542	6,886	59.7
Hamilton Management Corp		(4)	(4)	(4)	(4)	(4)	(4)
Insurance Securities, Inc	June 30	5,966	6,760	1,614	[5] 14,340	8,803	61.4
Investors Diversified Services, Inc	Dec. 31	19,313	8,131	6,002	[6] 33,446	13,889	41.5
Investors Management Corp	Nov. 30	6,709	2,257	96	[7] 9,062	4,099	45.2
Keystone Custodian Funds, Inc	Dec. 31	7,787	3,035	138	10,960	4,124	37.6
National Securities & Research Corp	do	3,362	959	197	4,518	2,061	45.6
Putnam Management Corp., Inc	do	4,475	3,478	437	[8] 8,391	1,636	19.5
Supervised Investors Services, Inc	Oct. 31	2,085	266	51	2,402	584	24.3
Vance Sanders & Co., Inc	do	1,502	4,686	242	6,430	3,301	51.3
Waddell & Reed, Inc	Aug. 31	9,958	13,840	275	24,074	10,283	42.7
Wellington Management Co	Oct. 31	5,385	1,806	167	7,359	3,650	49.6

[1] Distribution income is net of allowances to salesmen, agents, and dealers.
[2] Does not include equity in net income of unconsolidated subsidiary and net gain on investments.
[3] Includes $25,000 profit on sale of securities.
[4] Not available.
[5] Includes $250,000 gain on sale of options.
[6] Does not include operations of insurance subsidiaries.
[7] Company is a subsidiary of Anchor Corp. These figures include total operation of Anchor Corp.
[8] Does not include operation of Western Travelers Life, an insurance subsidiary.

Note: Totals may not add due to rounding.

AFTER-TAX EARNINGS AS A PERCENTAGE OF STOCKHOLDERS EQUITY OF THE 25 LARGEST BANKS—1966

	Stockholders equity (thousands) Dec. 31, 1966	After tax earnings (thousands) 1966	Earnings as a percent of stockholders equity
Bank of America	$935,514	$113,037	12.1
Chase Manhattan Bank	909,574	98,580	10.8
First National City Bank	923,175	104,890	11.4
Morgan Guaranty Trust	649,167	64,084	9.9
Manufacturers Hanover	545,670	55,925	10.2
Chemical Bank New York Trust	532,362	54,379	10.2
Bankers Trust Co., New York	364,000	44,696	12.3
Continental Illinois National Bank	437,604	49,130	11.2
Security First National Bank, Los Angeles	352,174	39,458	11.2
First National Bank, Chicago	411,241	44,660	10.9
Wells Fargo Bank, San Francisco	270,325	26,862	9.9
Crocker Citizen National Bank, San Francisco	217,088	25,676	11.8
Irving Trust Co., New York	208,669	19,142	9.2
United California Bank	226,314	21,602	9.5
Mellon National Bank & Trust	362,050	37,129	10.3
First National Bank of Detroit	226,025	23,457	10.4
First National Bank of Boston	254,898	30,496	12.0
Cleveland Trust	205,217	20,385	9.9
Franklin National Bank, Mineola	100,304	13,266	13.2
First Pennsylvania Bank & Trust	134,292	15,109	11.3
Philadelphia National Bank	115,461	12,396	10.7
Detroit Bank & Trust	112,744	12,487	11.1
Manufacturers National Bank, Detroit	78,776	9,317	11.8
Harris Trust & Savings	109,180	13,724	12.6
Seattle First National Bank	114,660	13,281	11.6

AFTER-TAX EARNINGS AS A PERCENTAGE OF STOCKHOLDERS EQUITY OF THE 25 LARGEST STOCK LIFE INSURANCE COMPANIES—1966

	Stockholders equity (thousands) Dec. 31, 1966	After tax earnings (thousands) 1966	Earnings as a percent of stockholders equity
Aetna Life Insurance Co	$432,061	$40,647	9.6
Travelers Insurance Co	471,010	48,201	10.2
Connecticut General Life Insurance Co	290,039	25,788	8.9
Lincoln National Life Insurance Co	405,479	39,573	9.8
Teachers Insurance and Annuity	61,096	11,461	18.8
National Life & Accident Co	279,078	28,741	10.3
Continental Assurance Co	158,518	14,840	9.4
Occidental Life Insurance Co	209,364	19,554	9.3
American National Insurance Co	245,222	20,124	8.2
Franklin Life Insurance Co	149,522	19,855	13.3
Jefferson Standard Life Insurance Co	161,592	14,898	9.2
Southwestern Life Insurance Co	93,504	7,794	8.3
Equitable Life Insurance Co. of Iowa	61,567	4,299	7.0
Life Insurance Co. of Virginia	94,765	9,071	9.6
Liberty National Life Insurance Co	99,028	13,851	14.0
United Benefit Life Insurance Co	89,411	5,924	6.6
Northwestern National Life Insurance Co	60,043	6,444	10.7
Kansas City Life Insurance Co	62,206	6,153	9.9
State Farm Life Insurance Co	64,845	10,484	16.2
Washington National Insurance Co	109,290	12,221	11.2
Life Casualty Insurance Co	79,702	9,675	12.1
Provident Life & Accident Insurance Co	58,100	7,182	12.4
Southland Life Insurance Co	30,056	5,560	18.5
Paul Revere Life Insurance Co	91,408	8,487	9.3
California-Western States Life Insurance	58,528	5,297	9.1

AFTER-TAX EARNINGS AS A PERCENTAGE OF STOCKHOLDERS EQUITY OF CERTAIN MANAGEMENT COMPANIES, 1966

	Stockholders equity (thousands) Dec. 31, 1966	After tax earnings (thousands) 1966	Earnings as a percent of stockholders equity
Anchor Corp	$4,449	$2,162	48.6
Dreyfus Corp	7,650	3,233	42.3
Insurance Securities, Inc	6,534	4,703	72.0
Keystone Custodian Funds	4,882	2,118	43.4
National Securities & Research Corp	2,976	1,113	37.4
Putnam Management Co	2,505	936	37.4
Supervised Investors Services	883	307	34.8
Vance Sanders & Co	3,058	1,171	38.3
Waddell & Reed	14,269	5,027	35.2
Wellington Management	2,956	1,861	63.0

Note: Distributors Group, Hamilton Management Corp., Investors Diversified Services, and Van Strume and Towne, Inc., have not been included, because it was not possible to secure comparable data for stockholders equity and after tax earnings.

Mr. COHEN. Now Mr. Chairman, I would like to take advantage of your offer and go back to my opening remarks. Incidentally, for the benefit of any who were not here when I testified last, I referred to this effort on the part of the sellers of funds, those who manage them, to seek the favor of investors. I introduced at the last time an advertisement put out by the Winfield Underwriters, Inc. in a recent publication. That organization is associated with a fund that had one of the best experiences in recent years and yet they have increased the dealer concession.

In other words, they have decided to take less for themselves out of the overall sales load. They have not attempted to reduce the charge to investors. This is the type of competition to which I have referred that exists in that area.

But going back to the advisory fee area, I do want to emphasize, even at the expense of repeating I think the last statement I made, that the industry can only come to where it is by a studious disregard of the situation as it exists. They argue that our proposal is ratemaking or profit regulation, and it is nothing of the sort. It is simply

a means for the enforcement of a fiduciary's obligations in a conflict-of-interest situation, and it is the traditional means for such enforcement, independent scrutiny by a court of equity, not by the SEC. I understand, and I am frank to say that I did not have a chance to read his testimony carefully, but I understand that the judge who testified suggested that perhaps in the best of all possible worlds, that scrutiny should in the first place be done by the SEC.

We considered that. We abandoned it. We did not wish anyone to have any notion that the Commission was reaching for additional power, and we wished to make as clear as we possibly could that this issue, when it arose, would be in the hands of an independent body in the traditional American way, in the courts of law.

Now while the industry insists that its fees should be reasonable, that they are reasonable, that they always have been and always will be reasonable, even in this conflict-of-interest situation, they are singularly reluctant to submit this question to any sort of independent and impartial review. Although, as I intend to point out in more detail later, we by no means suggest that all investment advisory fees are unreasonable, or even that most of them are, it would be singular indeed, given the situation which prevailed, if all fees have always been and always will be reasonable. No such suggestion finds any support in the record.

The dollar amount of fees has grown tremendously as the funds have grown, and this notwithstanding the fact, which the industry admits, that the costs of investment management do not rise very rapidly if at all as the fund grows, and I have just introduced some statistics which cover 1966, which the industry argued was a troubled year, and yet it reflects the fact that they did very well. They did a great deal better than any of the other financial institutions to which they have referred. I might say they did a great deal better than practically anybody else in the securities business.

Now fees and expense ratios of the large funds vary all over the place, and I must emphasize that our points have been directed to the large funds, because as the funds grow larger, the economies of size become apparent. Actually, this is the vehicle they created. They wanted a corporation. They wanted people to come in. This is where the word mutual may have an effect, Mr. Keith. By joining together, and as you grow you get the benefits of economy that a large institution provides. These people have been significantly reluctant to share in any fair way those economies with the people whose money they manage and who have made possible this unparalleled prosperity which they enjoy.

We are not against prosperity. We think that they should have profits. They should be reasonable profits. But we think the investor deserves some recognition too.

Now one large fund will pay $6 million and another about the same size will pay $3 million to be advised, and of course internally managed funds pay far less. In this connection, we also have a situation of a group of funds which have their own service organization, a service organization which takes care of the needs of the various funds at cost, allocated in proportion to the size of the funds, and it is very interesting, and if I may I would like to introduce the figures as they relate to that situation. I brought copies along for all members of the committee and anyone else having an interest in the matter.

Mr. Moss. Is there objection to having this included in the record at this point? Hearing none, that will be done.

(The information referred to follows:)

THE BROAD STREET GROUP: A CASE STUDY OF ECONOMIES OF SCALE IN MUTUAL FUND MANAGEMENT

The Broad Street Group is a complex of investment companies affiliated with and sponsored by a New York Stock Exchange member firm, J. & W. Seligman and Company. At 1966 year end, total assets of the groups's investment companies were $1,460 million.

The members of the Broad Street Group include:

(1) Tri-Continental Corporation, a closed end investment company formed in 1929 with 1966 year end net assets of $508 million.

(2) Broad Street Investing Corporation, an open end investment company which became affiliated with The Board Street Group in 1932, with 1966 year end net assets of $353 million.

(3) National Investors Corporation, an open end investment company which became affiliated with the Broad Street Group in 1942, with 1966 year end net assets of $555 million.

(4) Whitehall Fund, an open end investment company organized in 1947 with 1966 year end net assets of $15 million.

(5) Tri-Continental Financial Corporation, a wholly owned subsidiary of Tri-Continental, acting as a special situation investment company.

(6) Broad Street Sales Corp., a wholly owned subsidiary of Tri-Continental Financial Corporation, which acts as wholesale distributor of the three open end funds.

(7) Union Service Corporation, which acts as investment adviser to all the above investment companies. Union Service provides investment research, economic analysis, and supervison of the execution of purchases and sales of securities *at cost*. In 1963 it employed 92 persons of whom about half were economists or financial analysts.

Pursuant to an arrangement made in 1931, all of the above funds conduct most of their brokerage business thru the New York Stock Exchange firm of J. & W. Seligman. The principals of J. & W. Seligman and all of the above named companies (with the exception of Broad Street Sales) are, with some exceptions, the same persons. The major remuneration to these men comes from J. & W. Seligman and not from the investment companies listed above.

The nature of the organizational structure of the Broad Street Group in which management services are performed at cost affords an excellent opportunity to study the true cost of managing a mutual fund.

The shareholders of the Broad Street Group are able to enjoy a low, and decreasing expense ratio, as shown in Table I.

TABLE I.—EXPENSES OF BROAD STREET GROUP

	Average net assets of Broad Street Group (thousands) (1)	Management expenses (2)	Management fees as a percent of average net assets (2)÷(1) (3)	Total expenses (thousands) (4)	Expense ratio (4)÷(1) (5)
1966	$1,460,807	$1,602	0.11	$2,564	0.17
1965	1,411,438	1,543	.11	2,358	.17
1964	1,254,184	1,432	.11	2,263	.18
1963	1,085,623	1,378	.13	2,261	.21
1962	1,029,330	1,302	.13	2,092	.20
1961	939,492	1,208	.13	1,948	.21
1960	770,980	1,182	.15	1,856	.24
1959	681,008	(1)	(1)	1,633	.24
1958	552,144	(1)	(1)	1,497	.27
1957	474,047	(1)	(1)	1,415	.30
1956	451,979	(1)	(1)	1,207	.27
1955	388,590	(1)	(1)	1,085	.28
1954	301,144	(1)	(1)	997	.33
1953	253,357	(1)	(1)	912	.38

1 Not available.

Note.—While data is available from 1940 to 1953, Union Service Corp. managed other portfolios in addition to the Broad Street Group prior to 1953 and the data is therefore not comparable.

Mr. COHEN. This group of companies is called the Broad Street Group and this is a little memorandum prepared some time ago, not in connection with this testimony, but having read the testimony given by the others, I thought it important to bring this to the attention of the committee. As the memorandum indicates, the Broad Street Group is a complex of investment companies affiliated with and sponsored by a New York Stock Exchange member firm, J. & W. Seligman & Co. I should say that while the partners of that firm do receive salaries from the group of investment companies, and there are seven including the service company in the group, their principal remuneration is from the brokerage. But if you look at table I, without fussing with the rest, I think you can see what the management fee rates are, have been since 1960, the earliest date that we have figures for on management fee rates as a percentage of net assets, and what they are in 1966.

But we have figures going back to 1952 with respect to total expenses. The expense ratio, which includes not only the management fee but all other expenses, has been declining from 0.38 to 0.17.

We are not talking about new or strange things. We are not talking about things that some funds have not already done. Other large funds have undertaken other steps which have had the effect, even though they haven't changed their schedule of charges, but have had the effect of reducing the charges to the investor, and have brought them down to levels far lower than that which exists in a great many other comparable situations. Of course, there may be some differences between them, but I think it is a reasonable question why the range should be that wide, and why companies of comparable size should be subjected to such greatly varying charges. And obviously, it also points to the fact that perhaps the unaffiliated directors are not able, as I have suggested, to do a gerat deal about this situation.

Now these unaffiliated—well, before I get to that, I should say that it may well be, I want to be perfectly comprehensive if I can, that some of these fees are unreasonably high, and maybe others are unreasonably low. We are not suggesting that everybody's fees be brought down to the lowest level. We are not suggesting that anyone is too high or anyone is too low.

All we are suggesting is that if someone wants to put in issue, whether it is the SEC or a shareholder, the question whether the fee charged in his situation is fair, he should have an opportunity to do so without being hamstrung by doctrines which come about unintentionally because of certain provisions put into the act in 1940 by the Congress to help rather than to hurt the investor.

I think there is enough evidence before you in all the tables that have been submitted to you to indicate that these unaffiliated directors, even when they can concern themselves about the size of the fee, really do not have any alternatives. There is no real bargaining power.

But their presence in a sense provides an umbrella for the investment adviser. This is the point. Perhaps that is an inappropriate way of stating it, but that is the fact. As the judge pointed out, the doctrine of corporate waste prevents effective judicial review.

It is also somewhat anomalous that people who concede that they are fiduciaries, that the fees should be reasonable, are unwilling as a practical matter, no matter what they say, to have any independent body,

a court of law, review their situations except on a standard of corporate waste, which as every lawyer knows is at best the most difficult standard in the world, and at worst provides no remedy at all.

Now not only does the industry misconstrue the nature and the purpose of our proposal. They also misconstrue how it would operate in practice, and they do exercise their ingenuity, and by golly, they have a lot of it, in conjuring up imaginary or exaggerated difficulties rather than trying to devise workable means to avoid these difficulties while still protecting investment company shareholders and at the same time protecting themselves.

In the first place, they misconstrue the Commission's attitude and purpose. I am quite prepared to state that we do not regard all investment advisory fees as unreasonable, nor would we propose to embark on any campaign to cut the general level of fees way back to that of the lowest. I wish to restate that one of the important conclusions underlying our recommendation was that the economies of scale attributable to that growth and attainable as the funds grow, have not been adequately shared with the funds' shareholders. It is to this situation that our principal concern is directed.

I must point out, and the figures are before you, that a number of the people in the industry, and unfortunately there are not too many, did recognize the situation. Some of them recognized this many years ago, long before there was a Wharton School report, long before such a report was initiated, and they took steps to share these economies of scale with their shareholders. It really hasn't hurt them. They have sold as well as any. In fact, they have sold better. And the investment managers have done exceedingly well.

Now an argument could be made that these people who admit they are fiduciaries and are providing services to this corporation, to this institution that they create, should only be entitled for compensation for their services. But they say—and we are not for the purposes of this legislation taking issue with the suggestion—that they should also be entitled to some entrepreneurial profit. As I say, a reasonable argument could be made against it. We are not making it. We are accepting the fact that they should have some entrepreneurial profit, for those who have been successful in starting and building an investment vehicle.

We recognize, and it is the reason we came to this conclusion, that the creation and the building of a fund does involve certain risks, and that those who are successful are entitled to some reward. But that reward must be within reason, and at some point in time and growth, the reward will have been reaped.

Now the courts, as the judge pointed out, have traditionally been able to deal with these problems, and certainly the courts will continue to deal with them in the context of the particular situations.

I might say in this connection that another distinction between the mutual fund advisory organization and banks and insurance companies is that in an insurance company the owners of it, the shareholders, whether they be many or few, have to provide capital to quarantee the promises to the man who wants to buy a life insurance policy, and that is strictly enforced by the States. So also in the case of the banks. Their capital is at risk to take care of the obligations and

the promises of the bank. There is nothing at risk here so far as these investment advisory organizations are concerned, nothing at all. They don't guarantee any particular success or lack of failure or any level of asset value.

Now, turning to another point, we are accused of proposing to substitute our judgment for the judgment of the fund directors. This is wrong on at least two counts. In the first place, and I must emphasize it, any judgment as to the reasonableness of a particular fee would be made by the court, not by the SEC.

In the second place, if the directors really exercise a business judgment, if they do more than act as rubber stamps, if some of them change their views as to their responsibilities and do more than go through the rituals and feel that they do have an obligation to inquire and to seek justification, and they make a conscientious effort to arrive at a reasonable fee, taking into account all relevant factors, not only the ones we have mentioned but all relevant factors, and not merely rely on what the fellow down the street has been charging last year, I am certain, as I know all of you who have had any experience with the courts, whether as lawyers or as clients, must be, that the court would give appropriate weight to their judgment.

And as I mentioned, I believe I mentioned and if I haven't I should now, it would be appropriate for the legislative history so to indicate.

Now I come to another point that is somewhat related. It is a little more troublesome to me. It is in effect contended that we will engage in a sort of ratemaking by blackmail. I hope you will understand that I rather resent the suggestion. There is a suggestion made explicitly or sometimes implicitly that we will do something that we will of course not do. We will not require our opinions or the opinions of our staff about fees to be set forth in registration statements or prospectuses. We will not, we never have and we have been regulators and policemen for some 30-odd years now. We will not threaten suits unless we conclude that a suit is necessary to accomplish a statutory purpose, and that we have a case which we reasonably believe will persuade a Federal judge.

Now this raises an issue I want to repeat. We would, of course, conduct ourselves in all areas of our work by starting a lawsuit and asking qustions later. The suggestion has been made somewhere that this is a coercive authority. Now obviously whenever you have some authority and responsibility to enforce the law, it is coercive in that sense. But we would think that where a reasonable question arose, that we would want to bring it to the attention of the parties involved, and discuss it with them, just as we do in many other areas, and frequently they persuade us that we have been misguided, that we haven't been fully informed, and that our point of view should not be as was first suggested.

This could happen. But we would not, and again I must reemphasize, this Commission has never, and never will in my opinion, engage in this sort of blackmail which has been suggested.

Now in addition to being worried about the Commission, the industry is also worried about the small investor suing. We don't think that the courthouse door should be closed to him or that bars such as the standards of corporate waste should be erected in his path. In fact, the sum

and substance of their argument is they don't want anybody reviewing the situation.

There are, however, ways—if this is a problem—of avoiding unwarranted litigation and I am informed that in his testimony on Wednesday Judge Friendly pointed out some of them, and his suggestions certainly merit the most serious consideration by the industry and by us. And I am sure they will receive the consideration of the committee. But there may be additional steps which could be taken which we could develop if the subcommittee so wishes, although we have some reservations whether some of them go too far in protecting the managers at the expense of the shareholders of the fund.

Now in summary, industry witnesses have misrepresented this entire proposal. We do not urge ratemaking. We are not against profits. We do not wish to injure the investment advisory industry, and certainly none of our proposals would hurt the mutual fund industry, or even drastically alter the existing level of management compensation, generous as it may be. Indeed, we are not even suggesting a change in the structure of the industry, which in a large sense gives rise to the problems which we are discussing here today.

We have, however, a situation where the investment advisers can, and as I indicated in some instances have, enriched themselves at the expense of those to whom they stand in a fiduciary relationship free of any effective control or independent or impartial scrutiny. I want to make it perfectly clear that this is not true of all of them. Many of them have made an effort to share the economies of scale with their shareholders and have done so for many years. And they have not suffered in terms of sales, profits, or what have you.

Our purpose here is to restore to this area the traditional check on overreaching by fiduciaries, and that is impartial review in the courts of the United States.

Mr. Chairman, there were a few other questions that were suggested to which I might address myself. I will be glad to do that now or take your advice as to how to proceed. There were a few questions raised by some of the witnesses that I understood the subcommittee was interested in having some reaction from the Commission on. I can deal with those right now.

Perhaps I should make that clear. The subcommittee did receive a number of suggestions from other witnesses which relate to the matters I have just discussed, and it has been suggested that it would be helpful to the subcommittee for me to address myself to those matters. I don't think they will take a great deal of time, but I am at your suggestion.

Mr. KEITH. Could you ask, Mr. Chairman, as to the nature of those questions?

Mr. COHEN. Yes.

Mr. Moss. Those questions were raised by the witnesses?

Mr. COHEN. Right.

Mr. Moss. And for which answers on the part of the Commission would be supplied?

Mr. KEITH. I would suggest that we go ahead and try to comment on the statement he has made and then if time permits have further comments.

Mr. Moss. All right, you may proceed at your pleasure.

(The statement referred to follows:)

SUPPLEMENTARY STATEMENT OF HON. MANUEL F. COHEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. Chairman and members of the subcommittee, I deeply appreciate your affording me the opportunity to come before this Subcommittee for a second time to answer some of the objections that have been made to H.R. 9510 and 9511 and to clear up some of the misconceptions that may have arisen in the light of the testimony of certain representatives of the industry.

Over the past two weeks, I have carefully read the statements submitted to you by representatives of the securities business, as well as the transcripts of your questions and their answers on the points that have concerned you. I must confess that I found it a rather depressing experience because the industry has been so negative and unconstructive.

When I appeared before you two weeks ago, I told you that the purpose of these bills was a simple one—it was to provide a fair shake for the millions of Americans who have invested in mutual funds and other types of investment companies and for the additional millions who will invest in these media in the future. I want to reemphasize that basic purpose, because I think it is something we must not lose sight of.

The industry, however, insists that even if Congress should take the most modest steps to attain this goal, the health of the industry would be severely impaired. This is a familiar refrain heard in each of the hearings preceding the securities laws enacted by the Congress. In fact, these laws have served only to protect the securities industry itself from the consequences of overreaching by some engaged in that business.

There has not been a single advance in the regulation concerning securities which it was claimed would not have the effect of making business less profitable—or even impossible—for some segment of the industry. Some of you may recall the forecast that, if the Securities Act of 1933 were enacted, "grass would grow in Wall Street." Every improvement in the disclosure requirements has been made over the argument that it would make it impossible for some class of issuers to tap the public securities market. Every improvement in business standards has been made over the objection that it would be impossible for ordinary business men to operate under a crushing burden of government regulation. And after all these improvements, over all these objections, the securities business is bigger, stronger, healthier and more prosperous than it has ever been before.

The securities industry is a regulated industry. It has been regulated by the Federal government for more than a third of a century. The legislation before you is not an instance of government tampering with a free enterprise system. It is an adjustment of an existing regulatory statute to meet problems which were not present or even foreseen when that statute was enacted 27 years ago.

In many respects, these problems are attributable to the unforeseen consequences of Federal regulation. A great deal has been said in the last two weeks about competition in the securities business. The plain fact of the matter is that this business has a large number of competitors and very little competition. This may sound like a paradox but it is not. There are a great many separate units in the securities business, but they are severely restricted from competing with each other by the unique industry structure tolerated by and the anti-competitive protections afforded by Federal law.

In fact, the mutual fund industry does not compete on the basis of price for investor favor. There is little effort to offer a better price to the investor. The primary effort is to offer a better deal to the dealer and the salesman, so that they will push the shares of a particular fund to investors who have no effective way of evaluating different funds or of determining whether mutual funds are an appropriate investment for them at all.

This type of competition bears no relation to the classical free enterprise system. It is a "perverse" or "upside down" competition, which can exist only because the present scheme of Federal regulation of this industry makes it possible. It is a system of competition which brings enormous benefits to the industry, but not price benefits to the investor. It is a system under which the Federal government authorizes the industry to operate outside of the controls of the anti-trust laws, outside the controls provided by disclosure of compensation for management services, and outside the controls provided by a competitive free

enterprise system. The Federal government, together with the industry, shares responsibility for the excessive charges now being made to the American public for investment in mutual funds. Unfortunately, the industry has not seen fit to meet this responsibility. The arguments that have been advanced before this Subcommittee opposing H.R. 9510 ignore both the undisputed facts and the realities of 27 years of experience under the Investment Company Act. The Federal government must meet that responsibility by restoring a proper balance between the interests of the public and the interests of the industry.

I should like to turn now to a discussion of the particular issues involved and deal with the major contentions advanced by the industry.

1. THE BILL REFLECTS MODERATE CHOICES AMONG THE ALTERNATIVES AVAILABLE TO DEAL WITH THE PROBLEMS OF EXCESSIVE ADVISORY FEES AND SALES LOADS

Despite the industry charge that provisions of the Bill with respect to advisory fees and sales loads are "drastic",[1] they represent a moderate and conservative approach towards resolution of the serious problems in these areas. The problem of excessive advisory fees, for example, results from the conflicts of interest built into the external management structure of the mutual fund industry, a structure alien to the American way of doing business. The simplest way to deal with these conflicts of interest would be to eliminate them. This could be done by requiring the mutual funds be internally managed by their own officers and directors in the same way that most other companies, including financial institutions such as banks and insurance companies, are managed. Managers of investment companies, like those of other corporations, would then receive compensation for their services primarily in the form of salaries and other readily disclosed remuneration subject to conventional limitations instead of receiving gross management fees in a manner which obscures the excessive nature of these fees. The Commission, however, has rejected this approach as being too drastic at this time and instead has chosen to recommend only that the conflicts of interest inherent in the present industry structure be subjected to meaningful controls in the form of an express, readily enforceable standard of reasonableness. We know of no other means which on the one hand would deal adequately with the problem of excessive fees and on the other hand would disturb less the established structure of and ways of doing business in the mutual fund industry.

The need for controls over sales loads arises from the anticompetitive effects of Section 22(d) of the Investment Company Act, which interferes with the freedom of dealers to compete for customers by offering mutual fund shares at a price lower than that fixed by the principal underwriters of the funds. The industry claims that the present level of sales charges is reasonable and required by competitive conditions in the industry. However, when repeal of Section 22(d) was suggested to persons within the industry, they reacted with expressions of deep, and indeed almost violent, concern that the mutual fund industry could not survive the test of meaningful price competition. The Commission was not necessarily persuaded as to the basis for this concern. Nevertheless, it determined to adopt an approach which would deal fairly with the situation and which the industry would regard as a more moderate and conservative position. It determined not to recommend that existing restraints on competition in the sale of mutual fund shares be eliminated. It urged that investors be protected by a statutory ceiling on sales loads which would be subject to upward revision by the Commission when the public and investor interests seem to require such action.

With respect to front-end loads in the sale of contractual plans the Commission has recommended the abolition of this method of investing in mutual fund shares which for many purchasers has proved to be extraordinarily costly. It took this step, however, only because of the failure of the industry to develop meaningful alternatives which would protect adequately the substantial number of investors who, in fact, do not complete the payments on their plans. Many of these investors pay sales charges amounting to more than one dollar for every dollar invested in fund shares. Many of them, because of these unconscionable sales charges, have lost money on their mutual fund investments despite the rapidly rising securities market of recent years. Even so, the Commission did not

[1] See e.g., Statement of the Investment Company Institute, pp. 17–32. (Hereinafter referred to as "ICI Statement, —").

recommend abolishment of the contractual plan itself, which, in addition to the sales load, involves the imposition of an extra custodial fee to cover the administrative expenses of handling the periodic payments of contractual plan purchasers.

2. MUTUAL FUND ADVISORY FEES ARE EXCESSIVE

The industry does not seriously dispute the basic facts uncovered by the extensive studies that have led to the introduction of these bills. These facts are:

(a) There are substantial economies of scale in the management of investment companies. It should not cost 100 times as much to manage a $100 million dollar fund as it costs to manage a million dollar fund and surely it should not cost a thousand times as much to manage a billion dollar fund.

(b) Despite widespread recognition of this fact within the industry and despite the pressures generated by the Wharton School Report and by extensive shareholder litigation attacking the fees as excessive, the economies of scale have not been shared equitably with fund shareholders. In 1966 over one-half of the externally-managed funds with assets exceeding $100 million paid advisory fees of .48 percent of net assets or more, only 2 percent lower than the traditional .50 percent rate that is customarily paid by the small funds in the industry.

(c) The advisory fee rates of the larger external-managed funds on the average are *double* the average management cost rates of the larger internally-managed funds. There is no difference in the nature or extent of the services required in the management of these two types of investment companies.

(d) Mutual fund advisory fees for funds with assets of $100 million or more are on the average at least *8 times higher* than the rates charged by leading banks for investment advisory and other services to pension and profit-sharing plans with $100 million in assets.

(e) The same advisers who supply services to mutual funds can and do change *substantially lower fees* for management of the much smaller portfolios of private clients who, unlike fund shareholders, are in a position to, and in fact do, bargain effectively for lower costs.

(f) Advisers to mutual funds who contract out the investment advisory function to another advisory organization are able to do so for fees that are *a fraction of the fees* they charge the mutual funds under their management for these services.

(g) In many cases, the advisory fees paid by the larger funds bear no relation to either size or investment performance of the funds. Managers who serve larger funds often receive higher fee rates for comparable services than are managers of smaller funds whose efforts have resulted in superior investment performance. For example, the investment performance of Hamilton Funds, Inc., a fund with 1966 year-end assets of $490 million, which pays advisory fees at the rate of .50 percent per annum may be compared with the superior investment performance of Chemical Fund, Inc., a fund with year-end 1966 assets of $411 million, which pays advisory fees at the rate of .30 percent per annum.

Nevertheless, the industry persists in its contention that there is no need for a statutory standard of reasonableness with respect to advisory fees because the fees "are reasonable." [1] This is a barren claim wholly unsupported by the evidence.

3. THE INDUSTRY'S ATTEMPT TO JUSTIFY THE FEES AS "BARGAIN BASEMENT COST" TO THE INDIVIDUAL INVESTOR IGNORES THE BASIC CONCEPT OF A MUTUAL FUND

The industry has attempted to justify its failure to provide mutual fund investors with an equitable share of the economies of size by suggesting that an advisory fee of one-half of one percent is "bargain basement cost" for the professional management and diversification of investment risk which a mutual fund gives to its investors.[2] Of course, such an assertion ignores the total cost of a mutual fund investment. The combination of sales charges, advisory fees and brokerage commissions which an investor must pay in connection with his mutual fund investment represents the most expensive way ever devised by the securities

[1] ICI Statement, 23.

[2] Testimony of the Investment Company Institute, Record, p. 196. (Hereinafter referred to as ICI testimony, R —).

industry for mass participation in the securities market. Mutual funds costs are no more "bargain basement" than the quality of their product. Although mutual funds offer a security of high quality, the high cost of a mutual fund investment places investors at a substantial disadvantage in the achievement of their financial goals.

Justification of advisory fees in terms of the cost to the individual investor is inconsistent with the basic concept of a mutual fund. Mutual funds are created and sold to the public as a "mutual" investment median through the pooling of individual savings for investment in equity securities just as mutual savings banks offer a way to pool savings for investment in home mortgages and other debt securities and mutual insurance companies offer a way to pool premiums and thus, reduce costs of family protection. Our proposal that mutual fund advisory fees be governed by a standard of reasonableness would require that the economies of size be shared with fund shareholders. It would make the operation of mutual funds more consistent with the purposes for which they are created and the basis on which they are sold.

While the industry has created the funds and sold their shares with all the trappings and attractions of "mutual" savings institutions, its representatives attempted to suggest to this Subcommittee that the externally-managed fund is not a mutual savings institution at all, but more comparable to a stock insurance company.[1] But neither stock insurance companies nor a major segment of any other industry are characterized by the externally-managed structure, which compensates its managers not on the value of their services, but on the value of the company's assets. Such a method of compensation, which expresses the compensation as a fraction of one percent of the fund only obscures the many millions of dollars in managerial emoluments that flow from control of a mutual fund. The industry cannot have it both ways, selling shares in a mutual savings institution while abandoning any attempt to operate the institution for the mutual benefit of its investors.

Indeed, even in the ordinary corporate situation, where no attempt is made to create a corporate entity with the trappings of mutuality, the propriety of self-dealing transactions, such as management compensation, is not measured in terms of the cost per shareholder or cost per customer. When a director of a manufacturing company causes his company to deal with a supplier in which he has a financial interest and the supplier over-charges the company, the transaction has never thought to be justified on the grounds that it cost each shareholder only a few cents. Such a transaction is condemned as a breach of fiduciary duty because it contravenes the norms of the business community and the basic tradition of the law.

4. THE INDUSTRY'S ATTEMPT TO SHOW THAT ADVISORY FEE RATES ARE DECLINING IS BASED ON A MEANINGLESS STATISTICAL EXERCISE

Although at times industry representatives have suggested to this Sub-Committee that there is no duty on the part of fund managers to share the economies of size wih fund shareholders, at other times they have claimed that advisory fees are declining and the economies of size are being shared with shareholders. They support this claim by statistics which purport to show that since 1946 average advisory fee rates for all mutual funds have declined by 19 percent—from .46 percent of net assets in 1946 to .37 percent of net assets in 1966—and that total operating expenses during this period have declined by 28 percent.[2]

Advisory fees are almost always paid to the persons in effective control of the fund and constitute by far the major part of the operating expenses of a mutual fund. On the other hand, expenses other than advisory fees, which usually are paid to banks, lawyers, accountants and printers who are unaffiliated with the fund's management, constitute only a small portion of a fund's operating expenses. The industry's own statistics show that any reductions in advisory fees that might have taken place have failed by a wide margin to keep pace with the reduction in the other operating expenses of mutual funds, expenses which usually reflect payments to non-affiliated persons who stand in arm's length relationships with the funds and their managements. Thus, even the industry's own figures raise a serious question as to the adequacy of the sharing of the economies that they allege has taken place.

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[1] ICI Testimony, R 213–215.
[2] ICI Testimony, R. 198; ICI Statement, Exhibit 8.

Moreover, exhibit 8 to the Investment Company Institute's testimony, on which the claim of the 19 percent reduction is based, shows a strange and confusing picture. According to this exhibit, mutual fund advisory fees amounted to .37 percent of assets in 1966.

This same chart shows, however, that advisory fees in 1958, when the industry was only a fraction of its present size, amounted to .38 percent of assets—only 1 percentage point higher than the "average" of the 1966 fees. It also shows that in 1949 advisory fees averaged .40 percent of assets, only 3 percentage points more than the "average" 1966 fee rate. In 1949 the industry's assets were less than $3 billion. According to the industry's statistics, therefore, the economies of size were shared with fund stockholders, long before the funds had grown to the point where they had economies of size to share.

These contradictions in the industry's own data suggest that its claim of substantial reductions in advisory fees is based on an invalid statistical exercise. In fact, it is meaningless as a measure of the regulatory problems before this Congress because it is based on a weighted industry average which gives great weight to the relatively low fees paid by a few very large funds. The funds, including the internally-managed funds, which, as we have noted, pay substantially less for investment advisory services than the externally-managed funds. The plain fact, which the industry does not dispute, is that over one half of the largest funds—those with assets of $100 million or more—paid advisory fees at the rate of .48 percent or more in 1966. The fact that there has been little deviation from the traditional .50 percent advisory fee rate, which was characteristic of the much smaller investment company industry of the 1940's and 1950's, demonstrates the seriousness of the excessive fee problem.

5. THE INDUSTRY'S ATTEMPT TO DEMONSTRATE THE "MODESTY" OF ITS PROFITS IS BASED ON INVALID COMPARISONS

The industry has attempted to show that the pofits of mutual fund management organizations are "modest" by calculating the profits of 14 such companies not as a percent of revenues or shareholder equity but as a percent of the capital of the funds they manage.[1] The industry then compares these profit figures with the profits of the twenty-five largest insurance companies and banks as a percent of the public capital held by these institutions. This is an absurd basis for comparison. It is like determining profitability of a real estate management firm as a percent of the aggregate value of the property it manages or the profitability of a consulting engineering firm as a percentage of the construction costs of the projects it works on. It is the investment adviser, not the fund which receives advisory fees and makes profits. In many cases the pre-tax income of the adviser is very handsome, ranging up to 65 percent or more of their advisory fee revenues.

If a comparison is to be made of the profitability of mutual fund management organizations on the basis of capital, a more appropriate comparison would be profits as a percent of shareholder equity. On the basis of shareholder equity the profits of publicly-held mutual fund management organizations are, indeed, impressive. They show an annual return of 30, 40 and even close to 70 percent. In contrast, the median profit of the twenty-five largest insurance companies and banks selected for comparison by the Investment Company Institute amounts to a 9.8 percent and an 11.1 percent return on shareholder equity.

The Commission believes that the question of whether mutual fund advisory fees are excessive should not be decided solely on the basis of the adviser's profits no matter how computed. It is clear, however, that profits of mutual fund management organizations are hardly more "modest" than are the fees they charge their mutual fund clients. The industry should not be heard to justify its excessive charges by a fallacious statistical presentation as to the "modesty" of their profits.

6. THE INDUSTRY CLAIM THAT ADVISORY FEE RATES ARE EFFECTIVELY CONTROLLED BY COMPETITION, DISCLOSURE, UNAFFILIATED DIRECTORS AND SHAREHOLDER APPROVAL IGNORES REALITY

Despite the unbending rigidity of the advisory fee structure in the rapidly growing mutual fund industry, the industry claims that competition, disclosure,

[1] ICI Statement, 29–30; ICI Testimony, R. 202–203.

unaffiliated directors and shareholder voting are effective controls over the fees.[1] The facts are, as the industry well knows and twenty-seven years of experience amply demonstrates, that there simply is no competition in the advisory fee area, that unaffiliated directors have not been effective in keeping advisory fees reasonable and that shareholder voting has no effect on such fees.

(*a*) *Advisory fees are not subject to competition*

The industry apparently concedes that investment advisers do not compete for the privilege of serving mutual funds and that mutual funds have no real opportunity to shop around and seek the best terms they can get. If that were otherwise, surely there would be instances where the independent directors have successfully dislodged an adviser who was willing and able to continue. In fact, with one possible minor exception, there have been no such instances in the history of the industry. No proxy contest has ever been waged against, much less has one succeeded in displacing, an incumbent adviser to a mutual fund. Indeed, many independent directors suggested that it might be considered a breach of fiduciary duty to attempt to dislodge the adviser.

It appears from the industry testimony that the type of competition referred to is the competition among funds to sell their shares to investors; at the same time they attempt to establish that the invesment advisory fee is insignificant insofar as the average small investor is concerned. The two positions can hardly be reconciled.

The best indication of the role competition in sale of fund shares plays in keeping advisory fees reasonable is how those who sell mutual funds treat the fees in their selling literature. The fact is that even those funds with relatively low fees seldom emphasize that fact. Take, for example, the prospectus of Massachusetts Investors Trust. This fund, which is internally managed, pays its five trustees salaries which under any standard of executive compensation is quite handsome; yet their management cost rate of .12 percent of assets is less than one-fourth the traditional .50 percent rate. Its prospectus, however, makes no mention of these facts and indeed makes no mention of its relatively low operating expenses beyond that legally required by Commission rules. If the fees charged are important competitive factors, it is strange that those funds enjoying the lowest fees do not vigorously advertise that fact.

There is one group of internally-managed funds with relatively low management costs that does emphasize this fact in its selling literature. An official of this fund, however, has himself questioned its effectiveness as a sales inducement, except, perhaps, in extremely large transactions.

Although the amount of the advisory fee, which is a recruiting charge, is important to investors, their lack of awareness as to the fees is understandable. In addition to the fact that the amount of the fee when expressed as a small percent of the fund's assets tends to be obscured, it is hardly likely that the relatively small differences among the fees paid by most funds would be a determining factor in his selection of a fund. Nor is it likely that salesmen would invite the attention of the investor to any differences that may exist. They would also be inviting attention to the sales charge, which though paid only once, is more than eighteen times the .50 percent advisory fee.

(*b*) *The Industry Claim that Unaffiliated Directors are Effective in Keeping Advisory Fees Reasonable is a Myth*

We do not disagree that the unaffiliated directors can make valuable contributions by providing fresh ideas concerning particular industries or securities, trends in the economy and the general operation of the business. We believe, however, based upon the available facts from extensive studies, that the industry is perpetuating a myth when it persists in its contention that the unaffiliated directors represent an important additional factor in the "competitive" process affecting advisory fees. In the fee area, unaffiliated directors have not been effective and, in the nature of things, it is unrealistic to expect otherwise.

As we have said, competition among investment advisers for advisory contracts with mutual funds is generally unknown to the industry. Thus, the unaffiliated directors have no practical alternative but to accept the proposals of the adviser, and, at least in the past, they have tended to regard a renewal of the investment advisory contract as merely a matter of corporate routine, something like approving the minutes of the last meeting. Indeed, there have been a number of

[1] ICI Testimony, 198.

embarrassing instances where an investment advisory contract of a mutual fund was not renewed as required by the Investment Company Act simply because everybody concerned forgot about it. While such carelessness is uncommon, it is a symptom of the significance assigned to the ritual of approval. As one industry spokesman acknowledged, at most, the unaffiliated director's role is limited to "moral suasion." Apparently, in most such situations the advisers' fees have not suffered as a result of any suasion—moral or otherwise—emanating from the unaffiliated directors.

The attorney who prosecuted most of the shareholders suits involving advisory fees testified:[1]

"I said before I know one man—he happens to be associated with a man who is sitting near the door—who operates one of America's largest if not the largest investment company—who to my knowledge really stood up as an unaffiliated director, and when I tried to settle my lawsut he fought with me because he thought my proposed settlement wasn't adequate.

"And this I must say came with the same kind of shock to me as it did to you.

"But aside from that one man, in the 14 cases I have run into, involving, as an estimate, something like a hunded or more unaffiliated directors, I have not seen the counterpart of that in any case.

"These men, by and large, go along and rubberstamp.

"The proof of the pudding is that when these funds were growing from $100 million to $2 billion and they were getting a flat one-half of 1 percent advisory fee, wouldn't you imagine that somewhere, sometime, somebody among the unaffiliated directors would say, 'Now, look, fellows, this is getting a little out of hand. A $500,000 fee is not a $10 million fee. Wouldn't it be nice if we were to sit around the table to talk about reducing it from half a percent to three-eighths percent or some scale-down?'

"That never happened.

"Senator BENNETT. You're sure it never happened?

"Mr. POMERANTZ. It never happened.

"Senator BENNETT. You're sure?

"Mr. POMERANTZ. It never happened at the instigation of an unaffiliated director."

This is not cited as an indictment of the unaffiliated directors. Persons invited to join boards of directors do not normally do so to oppose the management or to bargain at arms length with their fellow directors who are affiliated with management. This is normally not considered their function. When it is necessary to nominate someone to serve as an unaffiliated director, all parties undoubtedly look forward to a harmonious relationship, and the unaffiliated director not unreasonably accepts the position upon that assumption. If an unaffiliated director were to suggest to his fellow affiliated directors that the fund has been charged an unreasonable advisory fee which should be reduced, the harmony of the board would in all probability be seriously disrupted. Unaffiliated directors, of course, know this and it is probably a factor which accounts in considerable measure for their inactivity in the fee area.

(c) *Over three decades of experience contradict the industry claim that stockholder voting is effective in keeping advisory rates reasonable*

The industry also suggests that existing requirements of shareholder approval constitutes an effective control over advisory fees, despite the well-accepted fact that, in most situations, the great majority of shareholders simply send in their proxies when the management requests them to. Shareholders acquiescence is hardly surprising. There is little else they can do. If shareholders should by any chance vote down an investment advisory contract they would leave the company without management and jeopardize their investment. But this possibility is purely hypothetical. It is commonly accepted, and many years of experience with proxy regulation in all areas of corporate life support the conclusion, that in the absence of organized opposition to a proposal, most shareholders either do not return their proxies or mark them in favor of management proposals. In the case of mutual funds the possibility of organized opposition is particularly unrealistic. Advisers do not compete for advisory contracts with funds by organizing proxy contests. And the possibility of a shareholder-initiated contest is also remote.

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[1] See hearings before the Senate Committee on Banking and Currency on S. 1659, 90th Cong., 1st Sess. (1967), p. 696.

This is not to say that proxies and the proxy statements are not meaningful. They are very useful as a disclosure device; but they do not and cannot control mutual fund management fees. Indeed, requirements of shareholder approval have only impaired existing controls. In the absence of such action courts will inquire into the reasonableness of advisory fees. But, as industry representatives have conceded, ratification by stockholders or approval by independent directors has caused some courts to require any shareholder who challenges a management fee in court to prove not merely that the fee is unreasonable, but as Judge Friendly has put it, that the fee is "excessively excessive" so as to constitute a waste of corporate assets.[1] This has heretofore proven to be an insuperable burden in management fee cases and has seemed to defeat the very purposes of the Congress in 1940 in providing the "few elementary safeguards" to deal with a problem that had not yet developed but now looms large on the horizon.

7. THE INDUSTRY WANTS TO REMAIN AS THE SOLE JUDGE OF THE REASONABLENESS OF ITS OWN FEES

The industry's own testimony indicates that it does not believe its protestations that competition, disclosure, unaffiliated directors and shareholders approval are "important" factors in reducing advisory fees. The statement of the Investment Company Institute asserts that "most of these management companies which have achieved their entrepreneurial goals have progressively reduced the rate of their fees over the years."[2]

The question might well be asked, who determines whether a management company has achieved its entrepreneurial goal from the fees paid by the funds it manages? Certainly not the unaffiliated directors of the funds! Time after time unaffiliated directors have stated that the profits of the investment adviser was no concern of theirs in evaluating the reasonableness of the fee and that it would be improper to suggest that the adviser disclose to them their profits from the management of the fund. Nor are the shareholders in a position to determine whether the management of their fund have "achieved their entrepreneurial goals." Indeed, the industry has strongly protested on each occasion where the Commission has suggested that the profits of investment advisers should be disclosed to shareholders as information material to evaluation of the reasonableness of the fees.

What the industry is therefore saying is that reductions in advisory fees should depend on whether an adviser has made enough money from the management of the fund it controls and the determination of that question should rest solely in the discretion of the investment adviser. Mutual fund shareholders should not rely upon adherence to the basic fiduciary standards of fairness in dealing with their advisers but must depend on the largess of the adviser. We do not think that such baronial self-determination is a substitute for a readily enforceable statutory standard of reasonableness where the trusteeship of people's money is involved.

8. THE INDUSTRY ADMITS ITS "VERY DEFINITE" RESPONSIBILITY TO SEE TO IT THAT THE FEES ARE "REASONABLE" BUT OPPOSES EFFECTIVE ENFORCEMENT OF THIS RESPONSIBILITY

The industry has conceded in testimony before this Committee that an investment adviser has a "very definite responsibility to see to it that the fees it charges are reasonable". Nevertheless, it complains that enactment of an express standard of reasonableness would "drastically" change existing law. Such a view is based on a misconception of the purpose of the bill.

As Judge Friendly has pointed out and the industry apparently concedes, the courts traditionally have held that those who manage or control a corporation have a fiduciary obligation to deal fairly with it.[3] Courts normally will inquire into self-dealing transactions between a corporation and its insiders and will upset such transactions unless the insiders can sustain the burden of proving fairness.

Mutual fund advisory contracts with affiliated persons are a classic example of a self-dealing transaction. In the shareholder litigation involving advisory fees,

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[1] Testimony of Judge Henry J. Friendly, R. 690.
[2] ICI Statement. 25.
[3] Testimony of Judge Henry J. Friendly, R. 689, 704.

however, the courts have held that because of the Act's requirements for approval of advisory contracts by shareholders and unaffiliated directors, the courts will not inquire into the fairness of advisory fees unless the plaintiffs can prove that fees are so excessive as to constitute a waste of the fund's assets. Proof of waste as we have noted, requires a showing that the fees are not only excessive, but "excessively excessive."

Thus, the Act's requirements of shareholder and unaffiliated director approval, which Congress intended as a protection for shareholders, has actually insulated the fees from judicial scrutiny. The purpose of the Bill is not to change existing law but to enforce it effectively by removing the unwarranted and unintended fetters to judicial scrutiny of the fairness of management compensation in the mutual fund industry.

It may be true, as the industry emphasized, that in applying the corporate waste doctrine to advisory fees, the courts have acted no differently than they might have with respect to self-dealing transactions involving ordinary commercial corporations. But as the industry also emphasized, the structure of the mutual fund industry is unique and its managers usually are not compensated like managers of ordinary commercial corporations. For this reason, the application of the waste doctrine is singularly inappropriate. It strips mutual fund shareholders of the only protection available to them against the overreaching that results where uninhibited conflicts of interests prevail.

If, like ordinary corporations, mutual funds were managed by their own officers, subject to the supervision of their own directors, then the stockholders would have the protection of the unbiased business judgment of the directors as well as meaningful disclosure of and conventional limitations on executive compensation. On the other hand, if mutual funds obtained management services from unaffiliated management organizations, then as sometimes occurs in the case of hotels and some other operations, then fund shareholders would have the protection of arms-length bargaining between the management company and their own directors assisted by officers having no personal interest in the transactions and owing loyalty only to the fund.

The problem with the externally-managed mutual funds in that neither of these protections exists. There is no arms-length bargaining as to fees and even the unaffiliated directors have no opportunity to exercise real business judgment, which implies the selection among available alternatives of that course of action which seems best for the business. In this situation independent review by a court, applying the standard of reasonableness which usually prevails where fiduciaries are in a position to fix their own compensation, is required to protect the interests of fund shareholders.

9. THE CHARGE OF "RATE REGULATION" IS WHOLLY UNJUSTIFIED

There has been a persistent effort on the part of industry spokesmen to characterize the Commission's recommendation, that investment advisory fees should be reasonable, as rate regulation, and then to say that this is not appropriate because mutual funds are not public utilities.[1] While the very argument is a semantic one, conjuring labels rather than providing analysis, we recognize that investment companies are not public utilities and for that and other reasons we do not suggest rate regulation. But it must also be recognized that insofar as supplying investment advice to the funds they control mutual fund advisers have an effective monopoly. For this reason we propose that the well-established standard, that fiduciary compensation must be reasonable, be applied to investment advisory fees and that where there is a question whether that standard has been lived up to, the determination be made, as it traditionally has been, by courts of equity. The courts, under the proposed standard of reasonableness, would not fix a schedule of rates for the industry, or for a particular fund; they would rather decide whether a particular fee submitted to them was within the range of reasonableness under all the circumstances. This, as Judge Friendly has noted, is a traditional function of the courts and is not unduly difficult to administer.

If the industry is satisfied, as it asserts, that the independent directors and other controls have kept fees at reasonable levels, they have nothing to fear from court review. The statutory proposal, which in a number of respects is less

[1] ICI Testimony, 206, 220; Testimony of the Investment Bankers Association, R. 248–251.

demanding than the common law rules as they apply to fiduciaries, would impose on the plaintiff the burden of proving unreasonableness; there would be no personal libility attaching to the directors; only the adviser would be liable and then only for the portion of any fees paid within two years of the commencement of a suit found to be excessive.

10. THE INDUSTRY'S CHARGE THAT THE COMMISSION WILL BE IN A POSITION TO CONTROL ADVISORY FEES DEFIES THE PLAIN LANGUAGE OF THE BILL

The plain fact is that under the provisions of the Bill, the courts, not the Commission, would determine whether fees are reasonable. Nevertheless, it is charged that the Bill would give the Commission the power to "control" the fees.[1] Such a charge only reflects the industry's posture of seeking to avoid any kind of independent scrutiny of the reasonableness of their fees. When actions by stockholders are suggested as a means of enforcing the standard of reasonableness the industry complained that this will produce "strike suits" and a multiplicity of litigation. If Commission action is suggested as a means of avoiding shareholder litigation, it is argued that the Commission may "coerce" the advisory firms.

If the industry is satisfied, as it asserts, that the independent directors and other controls have kept fees at reasonable levels, they have nothing to fear from court review. The statutory proposal, which in a number of respects is less demanding than the common law rules as they apply to fiduciaries, would impose on the plaintiff the burden of proving unreasonableness; there would be no personal liability attaching to the directors; only the adviser would be liable and then only for the portion of any fees paid within two years of the commencement of a suit found to be excessive.

Even though the courts, not the Commission, would determine whether fees are reasonable, it is suggested that, without recourse to the courts, the Commission will blackmail the adviser by requiring it to state in a proxy statement, or a prospectus, the opinion of the Commission or that of the staff, that the fee may be unreasonable although no litigation has been commenced, or is even contemplated. This implication of misconduct on the part of the Commission is totally unwarranted. If litigation with respect to a fee has been instituted, Commission rules require disclosure of the existence of such litigation to the extent that it is material. Those rules do not—and we would not—require disclosure with respect to the opinions of anyone associated with the Commission concerning the reasonableness of a fee at any other time. It would seem to be to the advantage of the fund advisers to discuss any substantial questions which may arise with the Commission before suit is instituted. It may be assumed that the industry does not want the Commission to sue first and ask questions later, yet they turn even this opportunity into one of coercive portent. This is nonsense.

Any possibility of litigation is, of course, in a sense coercive. In that sense a minority stockholder, whether or not our proposal is enacted, could "coerce" a mutual fund management by telling them the fee was too large and if they did not reduce it, he would file suit. In other areas, under existing legislation, the Commission has the power to initiate, and in many situations has initiated, litigation designed to halt violations of law. All such actions are also, of course, coercive in a sense. The industry position on this question comes down to the argument that no agency should be empowered to enforce the law because it might "coerce" people by telling them that it thought they were violating the law and if they didn't stop, it would be forced to take action. This possibility, which is inherent in the very existence of law enforcement agencies is not an adequate basis for declining to permit enforcement of the well-established fiduciary standard of reasonableness as to investment advisory fees.

II. THE INDUSTRY HAS PRODUCED NO MEANINGFUL ALTERNATIVES

Since publication of the Commission's Report in May, 1966, both the Commission and members of Congress have repeatedly asked industry representatives to come forth with workable alternatives to the proposals that have been set forth in the Bill. It has been made clear to all that careful consideration would

[1] ICI Statement, 31.

be given to any proposals submitted by the industry. Thus far, the industry has presented nothing except proposals that would serve to further insulate the advisory fees from judicial scrutiny. While it complains, for example, about the vagueness of the standards that we have recommended as appropriate for determining reasonableness of fees, it has made no suggestion as to changes in the standards made which would assist it in this apparent quest for greater certainty. The industry appears to be interested only in the kind of certainty that would flow from the absolute control over the level of the fees that it now has. It fails to recognize that mutual funds are affected with an important public interest which requires at the very least effective enforcement of the usual standards of fiduciary duty. Here corporate managers are dealing with the entities they control under conditions which involve serious conflicts of interest and marked differences in bargaining power between amateur investors and professional advisers who control billions of dollars of public capital in a few hands. We submit that the public interest requires this legislation.

II. WHAT OF THE EFFECT OF SALES LOADS REDUCTION ON SELLERS OF MUTUAL FUND SHARE?

During the hearings, much has been said about the adverse effect that the sales load provisions of H.R. 9510 and 9511 would have on those who sell mutual funds. The extent of this adverse effect has, we believe, been exaggerated. A decrease in gross revenue, if it occurs, may lower the income of at least some of the people who sell the item in question. Of course, this is based on the assumption that lower sales charges will not make fund shares more attractive and thereby stimulate sales. Upon this assumption, enactment of the bill would lower the earnings of many mutual fund sellers and may cause some of them to leave the business.

Now it is never pleasant to recommend a course of action that will make life for some people less comfortable. Nevertheless the Commission, after years of careful consideration, unanimously concluded that, if the price maintenance scheme in the statute—which has had the effect of raising costs—is to be continued, substantial reductions in mutual fund sales charges would be in the public interest and that legislative action to achieve that objective is needed.

If the mutual fund sales charges that now prevail were free market prices determined by the normal interaction of supply and demand, it might not be necessary to recommend the imposition of a statutory ceiling. But mutual fund sales charges are *not* free market prices. They are prices fixed and maintained by the fund managers under an exemption from the antitrust laws. That exemption—Section 22(d) of the Investment Company Act—permits the funds' principal underwriters to fix prices to which every retail dealer that sells these shares must adhere. No dealer anywhere (not even a dealer who has no contract or contact with the principal underwriter and who obtains shares from other sources, including investors) can deviate from the price that the principal underwriter has set. Since each principal underwriter seeks to induce dealers and salesmen both to sell mutual fund shares rather than other securities and to sell the shares of its fund or funds in preference to those marketed by competing principal underwriters, there is a constant upward pressure on sales loads. The strenuous opposition of almost every segment of the securities industry to the very thought of free retail price competition in the mutual fund business is based upon the assumption that the prices now paid by mutual fund buyers are far higher than the prices that would prevail in a free, competitive market.

It seems strange to some that, by and large, these high purchase costs to buyers have not resulted in high incomes for retail sellers. There is, however, a fairly simple explanation.

Selling mutual funds is an easy occupation to enter. Almost anyone not found guilty of a serious crime can become a mutual fund salesman. And since fund salesmen are, with rare exceptions, compensated on a pure commission basis, another salesman adds little to the employer's costs. Any sales that the new salesman makes (no matter how few or small) produce income for the employer. It is a case of the more, the merrier. There is a typical pattern. Each new salesman makes—or tries to make—sales to his friends and relatives. Carrying his selling efforts beyond that is more difficult. Prospects aren't that numerous because the ratio of salesmen to prospective investors is so high. In this connection, I might point out that Mr. Cornelius Roach of Waddell & Reed, Inc., estimated before

this Committee that there are abou 90,000 people selling mutual funds. Since there are approximately 4,000,000 mutual fund shareholders, there is, by Mr. Roach's estimate, a mutual fund salesman for every 44 existing mutual fund shareholders. Even if one were to estimate that there are only 50,000 mutual fund salesmen, there would be a mutual fund salesman for every 80 mutual fund investors. So it is inevitable that many full-time salesmen find it very hard to earn a good livelihood solely from the sale of fund shares. When a salesman does manage to unearth somebody who could invest in a mutual fund, he often finds that one of the army of part-time salesmen or a full-time salesman from a large New York Stock Exchange firm has already made the sale. Hence the turnover rate among saelsmen is very high.

In few other areas of the American economy does the labor force rotate at a comparable rate. New recruits who believe—or who are led to believe—that selling mutual funds is an open road to riches, or at least a dignified way in which to add a meaningful supplement to an income primarily derived from some other source, are offset by equal numbers of dropouts who have found that it isn't quite as easy to make money selling mutual funds as the recruiter said it was.

Just as it is relatively easy to become a mutual fund salesman, it is not difficult to become a mutual fund dealer. All it takes is $2,500 which can be borrowed. Many salesmen, who tire of sharing what they produce with their employers, venture into business for themselves. But the same obstacles that the proprietors of these new mutual fund retailing firms faced as salesmen still confront them and their sales recruits. Hence the high entry rate among mutual fund dealers is counterbalanced by a high departure rate.

The essential question thus becomes whether federal law should continue to insulate mutual fund sales organizations, which have probably grown oversized and inefficient in terms of production, from both price competition and price regulation.

The Commission is not insensitive to the legitimate needs of the mutual fund salesman and of the small mutual fund dealer for compensation. Indeed, as I have pointed out, the present system provides the seed for such failure. However, we must also consider—indeed, we must give priority to—the interests of some 4 million investors, most of whom are far from affluent themselves.

All of us are interested in minimizing unemployment. But investors should not have to combat unemployment by paying artificially high prices—prices protected by law, not produced by market forces—for mutual fund shares. It may be that, as one member of this Committee has suggested, there is a mutual fund salesman here or there who just couldn't possibly make a living anywhere else and who would have to resort to public assistance if sales loads were reduced. I would doubt that. But there are also a number of very large and very prosperous New York Stock Exchange firms whose reputations, whose contacts with hosts of investors, and whose extensive networks of branch offices enable them to sell large quantities of mutual fund shares. These member firms—roughly 10% of the broker-dealer community— account for 40% of all fund sales. The high mutual fund sales loads of today enable these firms (remember that they are the firms who get the lion's share of the very generous brokerage commissions the funds pay out when they buy and sell securities) to do very well indeed. And this stems from Section 22 of the Act which frees them from the price competition and from S.E.C. oversight responsibility that exists in other areas of the securities business.

High sales loads may be of some help to the weak in the securities industry. But the general public pays a tremendous price for that help. And most of that price goes into the pockets of the largest and the most affluent securities firms who are well able to fend for themselves.

The most invidious of the arguments put forward, however, is that these rewards for selling mutual fund shares are necessary to keep in business small and medium sized funds who underwrite small issues, make local markets, and so on. No proof has been offered to support this. There is no reason why underwriting and market making should not be profitable. But even if we assume it to be correct, it amounts to a claim that the unsophisticated investor—so they describe him—must continue to pay these high charges else the firms will discontinue all activity. In other words, the unsophisticated investor must subsidize the most sophisticated and more affluent investor who buys new issues or invests directly. This is, indeed, a strange argument.

What I have thus far said suggests, I know, that section 22(d) should be repealed and that mutual fund sales charges should be determined by market forces just as other prices are. There is much to be said for that suggestion, as Professor Wallich pointed out to this Committee. If we had to choose between things as they are and deleting Section 22(d), which would produce greater price competition than now exists, the Commission would seriously consider that as a step to deal with the present situation. Free competition would be an improvement over what we now have. And there are ways of equalizing the situation of the independent dealer distributed funds with those who employ captive sales forces. But that is not the only choice. There is another possibility which we included in the memorandum of alternatives provided to you which may be, from the industry's point of view, less drastic and which we, on balance, deem preferable to an all-out competitive regime. That alternative is to amend Section 22(d) to permit price maintenance up to, but only up to, 5%. We considered all of these, and while we were not persuaded that the industry's fears were warranted, we recommended the approach found in section 15 of the bill. Under the bill resale price maintenance would be preserved and the industry would continue to be sheltered from competitive pressures at the retail level, but mutual fund sales charges would be subject to a 5% ceiling with discretionary power in the Commission to permit sales charges of more than 5% in appropriate cases.

We think this approach somewhat preferable to price competition for a number of reasons. One is based on the view of some that independent broker-dealers and their salesmen would in all probability fare better under a 5% ceiling than they would under all-out competition. Those who hold this view urge that deleting Section 22(d) would produce real competition which might give captive sales organizations an advantage over independent dealers. It does seem a bit unrealistic to expect retail price competition to do much to bring down the price of those mutual fund shares which are sold only by a single exclusive retail distributor, at least immediately. Although this captive problem could be dealt with—for example, the law could require every principal underwriter to make the shares of its funds available to every registered broker-dealer who wanted to sell them—the Commission decided not to recommend any step that might tend to give large, captive selling organizations even a temporary advantage over their smaller, independent competitors. Also, it is impossible to predict just how much downward pressure retail price competition would put on mutual fund sales charges. While I am not persuaded that such would be the case, the industry has told us that market forces might drive the normal sales load far below 5%. If this occurred, competition would have a far more marked impact on the small retail dealer and on that dealer's salesmen than the Commission's present proposals could possibly produce.

In passing, I might observe that these considerations, to which the Commission gave much weight in its deliberations, ought to demonstrate that the S.E.C. is concerned about the small man in the securities business.

Moreover, there is, as the Commission has noted in its report on the Public Policy Implications of Investment Company Growth and its previous statements to this Committee, a second reason for the regulatory—as distingished from the purely competitive—approach.

Competition will undoubtedly do a lot for the knowledgeable, sophisticated, price-conscious investor. But what would it do for the widow who has never heard of the *Wall Street Journal?* Most people, not just widows, are not highly sophisticated in securities matters. They rely on the recommendations of securities salesmen who hold themselves out to have a special knowledge and wisdom in this complicated and risk-exposed business of equity investment. Comparison shopping is difficult for persons without all the tools of analysis at their command. Hence free price competition in the sale of mutual funds might well not achieve the desired result.

So at least it seems to us. But we have never denied that the question of competition versus regulation is an exceedingly close one. Perhaps it would be better to permit sales charges to be set in a free market than to set them by law. Our considerations led us to recommend a limited degree of regulation. Indeed, there may be other and more desirable forms of regulation. (One suggestion has been that the appropriate self-regulatory institution should attempt to deal with the problem in the first instance with adequate review and residual authority in the Commission. In this latter connection, I sent you a copy of an opinion of the Department of Justice which was provided at the request of Senator Ben-

nett.) But clearly it should be one or the other, and not the present state of neither competition nor regulation.

12. FRONT-END LOADING OF MUTUAL FUND SHARES

What has been said of the problem of sales loads on lump-sum purchases of mutual fund shares is applicable to a far more aggravated extent in the case of front-end load plans for the purchase of mutual fund shares.

The contractual plan is a device whereby shares of a mutual fund normally sold for an 8.5 percent sales load are sold on a front-end load basis to persons who wish to invest periodically. Under the contractual plan, the investor is expected to make payments, usually over 8, 10 or 12½ year periods.

It is a long term program for the investor, but not for the seller. The 50 percent front-end load deductions from the first year's payments amount to from ½ to over ⅘ of the total sales load to be collected from all the payments to be made over the life of the plan. The investor prepays a sales load on installments which he may never make. We have already seen from the statistics provided by the industry that this too often is the case. After the front-end load is collected, the salesman is much more intersted in making fresh sales and in collecting new front-end loads than in promoting persistency among those who have already been sold and whose continued payments give the sellers a relatively minor fraction of what they can earn from new sales. A visit to an inactive planholder may produce one $50 payment at trail commission rates. But the Special Study of Securities Markets found that on the average six installments are initially paid on a new contractual plan sale. Thus the sellers will immediately collect half of $300 on the new sale.

The contractual plan has been likened to the constitution of a certain important world power. On paper, it is a surprisingly high-principled document. In practice, those subjected to it do not reach the promised goals. The representatives of the contractual plan sponsors have not denied that their own statistics show that contractual plans have failed to achieve the advertised goal—the promotion of systematic and consistent investing by plan purchasers over a substantial number of years. The plan sponsors' statistics show that substantially less than half of contractual plan investors complete their plans and that, as a result, large numbers of investors (25 to 43 percent of their customers) end up, 10 and 12 years after their initial purchase, having paid sales loads of 20 percent to 50 percent—two and one-half to six times as much as is paid by those who purchase fund shares on a lump-sum or voluntary, level load plan basis.

There is no such thing as a salesman who sells contractual plans exclusively. He is a mutual fund salesman. Contractual plans are merely part of his line. Any knowledgeable customer who wishes to invest in the same mutual fund by purchasing its shares on a lump-sum basis or periodically through a voluntary plan can and will obtain them at the normal sales load. And, he can obtain them from the very same salesman who sells front-end load plans in shares of that very same fund. It is only the unsophisticated who pay the inordinately expensive front-end load.

13. IS MUTUAL FUND INVESTING BY PERSONS WHO HAVE BEEN UNABLE TO ACCUMULATE SAVINGS FOR INVESTMENT PURPOSES SO DESIRABLE THAT A 50 PERCENT FRONT-END LOAD SHOULD CONTINUE TO BE PERMITTED UNDER THE INVESTMENT COMPANY ACT?

Even if we assume the desirability for some investors of this inefficient way of selling, i.e., of going to the homes of prospective customers, is the front-end load equitable when there is a good likelihood that a large proportion of those to whom salesmen are motivated to sell will not make future investments for which the front-end load is largely a prepayment?

Congress must decide whether it is good to have a type of selling which, according to its own proponents, depends for its very existence on the extraordinary subsidization of sellers of mutual funds by the many persons who pay the front-end load but cannot, or who for other compelling reasons, do not complete the plans.

It has been said that the front-end load brings the advantages of equity investment to many persons who otherwise would not invest. But according to a survey of mutual fund shareholders submitted by the Association of Mutual Fund Plan Sponsors, 47 percent of contractual plan holders do own common stocks. Sellers of those common stocks were able to reach these persons although the applicable sales charges were far less than those paid on contractual plans.

14. IS THE FRONT-END LOAD JUSTIFIED BECAUSE MOST OF THOSE WHO HAVE INVESTED IN CONTRACTUAL PLANS HAVE MADE OR COULD REALIZE A PROFIT DESPITE THE FRONT-END LOAD DEDUCTIONS?

Despite the generally rising levels of the stock markets during the past 15 or 20 years, 10 and 12 years after purchasing contractual plans, 25 percent and 33 percent of the investors in two of the four contractual plans which have submitted data had lost money.

Nor have the plan sponsors denied that most of those who lost money did so because of the front-end load deductions. In view of the generally rising market levels, very few would have had a loss had the usual sales load deduction been applicable rather than the front-end load.

Even more important, perhaps, is the fact the the risks created by this form of selling are borne solely by the planholders. The sale of a security does not create a profit-sharing arrangement between the broker-dealer and his customer. Yet the sellers take one-half of the first year's payments and only half (or less) of the investor's payments for that period go to work for him.

15. WHAT REMEDIES DO THE PLAN SPONSORS PROPOSE?

The plan sponsors have admitted that this area deserves attention and that these problems were "actually called to our attention primarily by the SEC."[1] The remedies they offer are, however, woefully inadequate.

One such suggestion is to extend the 30-day refund privilege, presently offered by plan sponsors that account for 70 percent of the contractual plan business, to all contractual plans. However, experience shows that this privilege does not reduce the high redemption and lapse rates on contractual plans.

The Special Study's survey of contractual plans sold in February 1959 found that 3½ years later the combined figure (36.6%) for redemptions and lapses on contractual plans sold with the 30-day refund privilege was higher than the comparable figure (32.9%) for contractual plans sold without that privilege.[2]

Another suggestion made by the plan sponsors is that they be given a fair chance to demonstrate that they can improve planholder persistency. Over four years have elapsed since these problems were discussed in the Report of the Special Study of Securities Markets. Yet we have been told that *one* sponsor has initiated a series of follow-up letters to customers who cease making payments. The Commission does not know the pertinent facts of that experiment. We do know that the Special Study found that a substantial portion of reactivated accounts subsequently became inactive once again.

For four years the Commission has eagerly awaited evidence of self-regulatory procedures that have substantially improved the front-end load situation. We are still waiting.

16. WHY IS DISCLOSURE A PARTICULARLY INADEQUATE PROTECTION FOR THE CONTRACTUAL PLAN INVESTOR?

Some members of this Committee have questioned why, given the present regulatory limits on front-end loads, disclosure is not adequate to protect investors. In a similar vein, some have wondered why disclosure of the front-end load coupled with an offer of the 30-day refund privilege is not adequate to protect investors against "overpersuasiveness" by salesmen.

These are reasonable questions. But the hard fact is that the front-end load deduction, in effect, commits a purchaser to invest in shares of a particular mutual fund usually over ten years on the basis of information supplied to him at the time he begins the plan. At the time he is sold the plan, and, indeed, for years thereafter, he may be satisfied that he will be able and willing to complete his payments.

But how can he know what his financial future will be? Adverse personal circumstances long after the sale may render him financially unable to continue his purchases—and I do not suggest, as the plan sponsors have, that those circumstances are limited to his being unemployed or suffering an illness which results in his being unable to continue in his employment. He may have an unexpected

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[1] Testimony of Association of Mutual Fund Plan Sponsors, Inc., R. 441.

[2] See *Report of Special Study of Securities Markets*, 88th Cong., 1st Sess., House Doc. No. 95, Pt. 4, p. 263, Table XI–11.

need to support relatives unable to care for themselves. He may have unforeseen expenses in providing for his family. His income may not keep pace with increases in the cost of living.

Moreover, disclosure is helpful primarily in evaluating the *present* merit of an investment. In the case of the contractual plan, we deal with long periods during which there may be significant changes in the investor's personal situation, in the general economy, and in the performance of the underlying fund. The planholder's investment goals may change. If he bought a plan in a balanced fund, he may later decide that it is more desirable that his investment henceforth should be in a growth fund. Or an investor may decide that the management of the fund he has been investing in has not lived up to his expectations and that he wishes to allocate his future savings to another fund with different investment goals. Other mutual fund investors can and do make such decisions.

The contractual plan investor is penalized to a uniquely heavy extent if he decides to invest elsewhere in the future. The disclosures and the refund privilege offered him at the time of his purchase have no bearing on these future contingencies.

Mr. KEITH. Mr. Chairman, you have given our committee and the Congress and the country much food for thought, consideration, and action, I suspect. But when you say none of your proposals would hurt the mutual fund industry, you attempt, it seems to me, to discredit the entire presentation of the case by those seeking to defend themselves. I think it is this committee's responsibility to make that judgment. I certainly am not going to buy that conclusion. I don't think you have proven that point as yet. You have given us cause for thought.

Mr. COHEN. Mr. Keith, so that I can understand what you are pointing to, when you say the mutual fund——

Mr. KEITH. I am not pointing at anything. I am just pointing out, and I took it down as well as I could, a sentence in your concluding commentary to the effect that "certainly none of our proposals would hurt the mutual fund industry."

Mr. COHEN. I am talking about the mutual funds. I am not talking about the sellers and I am not talking about the managers. Obviously, our proposals will have some impact on them.

Mr. KEITH. So you are saying it wouldn't hurt the mutual funds.

Mr. COHEN. That is what I said, and as to the latter point, if you wish to put it to me, I would be glad to expand my answer in those areas, but I want to make it perfectly clear I am talking about the mutual fund as an investment vehicle.

Mr. KEITH. I see.

Mr. COHEN. Our purpose here is not to hurt them, but to improve them, to make them more attractive, to make them easier to sell.

Mr. KEITH. I am quite certain that your purpose is that. I don't question your purpose. It may be a matter of semantics as to where one leaves off and the other begins, but at any rate you are now pointing out that the word "industry" was not intended or perhaps not in fact present in that quote that I made.

Mr. COHEN. Well, if I misled you I am sorry, Mr. Keith.

Mr. KEITH. No, that is all right.

Mr. COHEN. I meant to emphasize that none of our proposals are directed at mutual funds as such, their viability, continued viability, growth, and usefulness. Our concern is with respect to the charges which are levied upon investors in acquisition of an investment in such a fund, and the maintenance of such an investment.

Mr. KEITH. I am glad I pointed it out. I think that your explanation is appropriate. As we draw nearer to conclusion of these hearings, you have made a rather dramatic portrayal of the profits of these management companies, and it seems to me that we should be seeking ways to open this business up so that supply and demand can have an impact on this problem. More people should get into it, and let the law of supply and demand become effective. This is the problem that we have had, and I don't see——

Mr. COHEN. This was the first question to which I was going to address myself, Mr. Keith.

Mr. KEITH. Go ahead.

Mr. COHEN. I understand that Professor Wallich suggested, and some others have, that our recommendation in the area of sales load doesn't go far enough, or that there is an alternate approach which might be better, and that is to repeal section 22(d), which would eliminate this federally enforced price maintenance provision and exemption from the antitrust laws, a result which conceivably would meet the objective you have just stated, by opening up to many more people than is now possible a willingness, or an opportunity and a willingness, to invest in these funds because acquisition costs might be more moderate than they are today.

This is the proposal Professor Wallich made. To the extent that the Commission has been criticized in the public print, and we have had very little criticism editorially, but when we have been criticized, it has only been in this particular area, that we haven't gone far enough, that we should not abide this situation, which perhaps might have been appropriate at a time when this was an infant industry, but rather rely on free competition.

Now I think this is a legitimate question, and the Commission considered it very carefully. I can't tell you how many hours we spent on this. And, as I indicated in my testimony when I appeared here before, 6 or 9 months before we issued our report I called in the leaders of the industry, and I said that this was a proposal which had been put forward for our consideration, and that before the Commission acted on it, it would be most helpful to the Commission to have the benefit of the views of everybody concerned.

Universally they objected to it. They raised all of the questions and objections which have been raised here before you when the question has been put.

So far as the Commission is concerned, I would have been and the Commission would have been in a more appealing position than had we wrapped ourselves in that mantle of free competition. I think the statement I used, which was perhaps a little gaudier last time, was that I might ride down Pennsylvania Avenue on a white horse with the shiniest armor possible. Nevertheless, no matter how attractive that seemed to be, we decided against it, and there were several reasons why we did.

In the first place, there is some uncertainty as to the consequences of repeal of section 22(d). I must emphasize, if I can digress for just a second, because Mr. Watkins wasn't here when I attempted earlier to explain, that this is not like a fair trade law in a State, and there are

some States that have them, where the manufacturer or the distributor enforces the law by bringing action against somebody who does not keep to the fair trade price. This is a federally enforced thing. Everybody must comply, and if a dealer wants to cut the price, and if he does it more than once so he is being deliberate about it, the Commission may have to consider whether or not we want to refer him for criminal prosecution. At the very least we might have to take action by way of injunction.

The Federal Government enforces this, and I know of no other situation like it.

Now the industry——

Mr. KEITH. You are going to speak to the unique reasons.

Mr. COHEN. Yes, sir; I am coming to this.

Mr. KEITH. As to why this should be enacted by Congress.

Mr. WATKINS. Mr. Chairman, will you yield?

Mr. MOSS. Mr. Watkins.

Mr. WATKINS. Why do you direct that to me so much? I read your testimony.

Mr. COHEN. I am sorry, I am just turning this way and that. I don't think I have been paying you enough attention until now, Mr. Watkins, and I want to give you an equal amount of attention.

Mr. WATKINS. I have been sitting here listening and I have been quiet today. I don't know if you have had the benefit in this rebuttal, you are accorded the privilege of coming in here after reading the testimony of every witness and knowing everything that has been said here, and with a very capable staff, that is certainly available to you at your wishes to compile a record which I have been sitting here and listening to, and which I appreciate. I like to listen though I don't always agree with what I hear. But——

Mr. COHEN. This is a disease that all of us have on one occasion or another.

Mr. WATKINS. You talk about the various States and all. You get into that. In compiling your facts and all, have you ever called on the State of Pennsylvania Securities Commission?

Mr. COHEN. Have we what, sir?

Mr. WATKINS. Have you ever called in the State of Pennsylvania, the Securities Commission?

Mr. COHEN. On this issue, no.

Mr. WATKINS. To get their views on what is happening. We are regulating there.

Mr. COHEN. Mr. Watkins, we meet fairly regularly with all of the State commissioners. We attend their annual meetings. We have liaison meetings with them, in many areas including the area concerning which we are now speaking, and I can say to you, I don't remember particularly now the action of the Pennsylvania commissioner, but a great many "blue sky" commissioners—and I believe in conventions—they passed a resolution adopting, enforcing and encouraging the recommendations we have made to this Congress. I am talking now about the convention of all the State administrators.

Mr. WATKINS. Endorsed your recommendations?

Mr. COHEN. Yes, sir.

Mr. WATKINS. They did? Endorsed the 5-percent ceiling?

Mr. COHEN. They endorsed them all, sir.

Mr. WATKINS. I would like to see that.

Mr. COHEN. Yes, sir, we will provide it for the record. It is a resolution of the North American Securities Administrators, which consists of all the State administrators, all 50 of them, the administrators in the Canadian Provinces and the administrator in Mexico.

(The following letter was received by the committee:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., October 24, 1967.

HON. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In my testimony this morning, I mistakenly stated that the state securities administrators had adopted a resolution supporting the Commission's recommendations for amendment of the Investment Company Act. In fact, as I have been informed today by the President of the North American Securities Administrators, that Association has not taken any position on the proposed legislation.

The expression of support to which I should have referred was an editorial in the "Blue Sky News" for December 1966 by John K. Kyle, the then secretary of the NASA and for many years the distinguished securities administrator of the State of Wisconsin. The "Blue Sky News" is issued monthly by the NASA. I enclose for your information a copy of his editorial, entitled "Support the SEC Mutual Fund Recommendations."

I wish to express my apologies to the subcommittee for this misstatement.

Sincerely,

MANUEL F. COHEN, *Chairman.*

SUPPORT THE SEC MUTUAL FUND RECOMMENDATIONS

(An editorial by John K. Kyle, editor, Blue Sky News)

The comprehensive report and recommendations of the Securities and Exchange Commission for changes in mutual fund regulation have been sent to each administrator, in both summary and complete form. They have been covered extensively in the financial press. For this reason, we are not taking space in your own publication to repeat the information. We are, therefore, devoting what space is available this month for comments thereon.

North American Securities Administrators, as an organization, has had no opportunity to act as a body. There will be no such opportunity to act until the September meeting, except through committees or possible referenda. The views expressed in this editorial are necessarily those of the editor as an individual. Any contrary views, criticisms, or comments by administrators are invited, and will be given equal space in forthcoming issues of your publication.

I have indicated to the Securities and Exchange Commission that I am in accord with each of the recommendations. We, in Wisconsin, were especially pleased to note the proposal for legislation to do away with the so-called "front end" load, or to use an industry-coined term, "contractual plan." While only four or five states are currently without the "front end" type of sales commissions, we know that many administrators have had serious misgivings about them. They have been accepted in many states only because of an unrelenting campaign for them by those who prosper from their sales. There is no issue which has come before the Wisconsin department, during my term, which has generated more pressure, ranging from charming persuasion to blustering near threats. These plans are unfair and inequitable, both to those unfortunates who find it necessary to discontinue investments before completing their programs, and to those who do continue making their payments until the end. The former lose up to half of the money they invest. The latter suffer from having only half of their money going into their investments, "in shares of American industry" during the early years. That lack of early investment of a substantial portion of their investments continues to handicap the results sought to be obtained from these programs.

Reports in the Wall Street Journal, in the first issue following publication of the report indicate that various industry groups had already moved to

present a "united front" with conferences between the various groups already being scheduled. There will be, of course, a natural reaction to any regulatory plan designed to give mutual fund investors more of the returns from their pooled funds, brought about by abolishing the present "double commissions" and higher rates than are charged elsewhere in the investment industry.

The clear obligation of administrators, both state and federal, is in the direction of protecting the investor. This report is the third of a series, made by independent and impartial study groups. All have reached the conclusion that there has been overreaching for compensation, which needs legislative and administrative correction. We, in Wisconsin, are giving consideration to the possibility of public hearings on some of the proposals, giving industry and organized and unorganized investors a chance to be heard on the merits of these plans. We sometimes think too many securities regulation patterns are developed in "chambers".

"POOR AUNT JANE"

There has already been an indication of the type of argument which will be used by industry in an attempt to defeat the SEC recommendations. Keith Funston, President of the New York Stock Exchange, recently made a speech before the American Management Association. He apparently knew of the concern of administrators over the "give-aways" of about half of the commissions charged mutual funds and other institutional investors for the handling of large portfolio transactions. Twice in the speech and twice in the highlight summary, Funston cried that "to give a big institutional customer a preferential break over Aunt Jane would offend the public interest."

No one has proposed changing the commission rate charged the mythical Aunt Jane in those cases where the transaction is small and there must be a minimum charge so the dealer will not lose money on the deal. This is a recognized business practice similar to the charge made when Aunt Jane, with her limited resources and appetite, buys a quarter of a pound of butter at the store instead of a full pound.

Mr. Funston's argument ignores the thousands of Aunt Janes and Uncle Llewellyns, who have pooled their investment funds in mutual funds. According to advertising of the sponsors, they have been joined by ivy-walled colleges, trust funds, and other good folks who are looking for dependable and honest money managers to invest for them. What has been happening?

When Aunt Jane and Uncle Lew pool their money this way, the amounts involved are so large that dealers handling portfolio transactions have been saying: We don't need the full commissions to be properly paid for our work, and can't we find somebody to whom to give about half of it.

But poor Aunt Jane and Uncle Lew, whose collective money generated these commissions, don't get the benefits. The portfolio dealer and the fund managers and underwriters look around for someone else to share in the largess. Much of the time they discover other dealers, who have already been paid 7 to 9 percent for selling shares in the fund to a new group of Aunt Janes and Uncle Lews. And they give away, what properly belongs to Aunt Jane and Uncle Lew, to these salesmen, in the form of a kind of bonus.

It is plain that in the forthcoming debate it will be up to those charged with protecting the public interest, to unmask these arguments and to see that the right concern is expressed for not only the good old aunts and uncles, the "widder" Browns, and the young parents planning for their children's college education, for retirement, etc., etc.

Mr. WATKINS. Personally, I feel as though no one wants to keep this thing going at—I think perhaps your study has been very good but as I said, I think we have to go much further. I think you have infringement upon State rights and on the cost, and you want to regulate this one industry with a fee.

Mr. COHEN. There is no infringement on State rights, sir.

Mr. WATKINS. That is questionable.

Mr. COHEN. The statute makes it clear that there isn't. It so provides.

Mr. WATKINS. I wonder yet with all the testimony you haven't said just why you are so interesting in putting this 5 percent level on, subject to court approval, of course.

Mr. COHEN. Well, if I can complete my answer to the question put that I was just dealing with, I may deal with some of the matters you have raised, Mr. Watkins, and if I haven't I will be glad to expand it in any way that you wish me to.

Mr. WATKINS. I am sure that the Commissioner has the exceptions I have taken. You have read those exceptions I judge, haven't you?

Mr. COHEN. I have read most of the transcripts, yes, sir, and I think there may be a little disagreement of opinion, but perhaps I can persuade you today.

Mr. WATKINS. If I am not correct, will you correct me on this. I understand the State of California, which State our distinguished chairman is from, I take no exceptions with this, that for many years there has been the opinion that the sales load was at about 10 percent, and I find that other States run anywhere from 9 to 15 percent.

Mr. COHEN. Mr. Watkins, those States don't direct that fee. They permit the payment of that fee.

Mr. WATKINS. That is right. Now you say you are not infringing upon State rights.

Mr. COHEN. No, sir, I am not.

Mr. WATKINS. You are setting down a rule that it will be five percent in every State of the Union, wouldn't it?

Mr. COHEN. There is no State in the Union that requires the payment of any fee because many no-load funds are sold in those States.

Mr. WATKINS. That is true.

Mr. COHEN. Now if the Congress believes that this is a national problem, and it decided this a long time ago, 27 years ago, and determines to adjust the statute now to meet current needs and obligations, this is no infringement at all. It is perfectly consistent with States rights and State provisions.

Mr. WATKINS. I think you don't need to pursue it any further. I think it is an infringement, with all respect to you. I am certainly of the opinion that it is a competitive business. Are you?

Mr. COHEN. It is a competitive business in the manner in which I have described it. It is a business which—

Mr. WATKINS. You say it is a competitive business.

Mr. COHEN. In the manner in which I have described it, Mr. Watkins.

Mr. WATKINS. Why with a competitive business, why should your Commission or why should I in the Government become the mother and go into competitive business where it is a free enterprise and has the right to operate.

Mr. COHEN. Because the Congress already did that in 1940 by putting this price fixing scheme in the statute. That is not competitive business. This is what I was trying to speak to at this particular time. The statute now, and since 1940, interferes with competitive business in this area.

Mr. WATKINS. Not to the extent that you are proposing.

Mr. COHEN. I am sorry, sir. The statute is unequivocal. No person, no matter where he gets it, from the issuer, from another dealer, or even from a private person, no broker-dealer may sell a share of a particular fund at a price less than that fixed by the issuer.

Mr. WATKINS. True.

Mr. COHEN. That is not competition as you and I normally expect it, sir.

Mr. WATKINS. Well, the price of the shares are generally uniform anyway.

Mr. COHEN. No, sir; I don't think that is so.

Mr. WATKINS. Do you consider the industry to be a monopoly? Do you think they have a monopoly on it?

Mr. COHEN. No, the industry is not a monopoly in the sense that you use it, sir. There is competition as among funds. This is true.

Mr. WATKINS. You bet there is competition.

Mr. COHEN. But if I may answer your question, sir, the competition is an unusual one. It is a competition not for the customer, not for the investor's dollar. It is a competition for the favor of the salesman, by offiering him more and more remuneration, which the investor has to pay. That is the kind of competition it is. The normal competition you and I know is to try to get the business away from somebody else by offering him a better service at a cheaper price and in a more timely manner. That doesn't exist here.

Mr. WATKINS. There is nothing wrong with that. I think it does exist. In other words, the larger company that operates in a more progressive manner, they have had research and they have better investment advice——

Mr. COHEN. They all have research.

Mr. WATKINS. They can give a better price perhaps than a smaller firm that wasn't available to them perhaps.

Mr. COHEN. As a matter of fact——

Mr. WATKINS. It is competitive, then the smaller firm would have to meet the price of the larger firm, wouldn't it?

Mr. COHEN. It doesn't work that way. But as to a particular fund, the shares of A, B, C fund, whether you are a big firm or a small one or a medium, you cannot change the price.

Mr. Moss. You have exceeded your 5 minutes.

Mr. WATKINS. You mean you are shutting me up, Mr. Chairman, with just 5 minutes? I might just as well go over to the House of Representatives and start to do a little work. Is that all I am going to have here or can I have many 5 minutes?

Mr. Moss. I don't think the Chair has to apologize nor would the Chair apologize to any member of this committee for protecting their rights in permitting them the widest of latitude. The Chair has a responsibility to the committee to conclude these hearings, and the Chair intends to discharge that responsibility.

The question pending directed to you by Mr. Keith is relevant to the question of section 22(d). Will you address yourself to that?

Mr. COHEN. Yes, sir. I think I was at the point of saying——

Mr. WATKINS. A parliamentary inquiry, Mr. Chairman.

Mr. Moss. Mr. Watkins, the Chair has given you more time than the rules require. He has attempted to afford you the widest latitude, and all that we have as a result of it is a philosophical discussion which has added nothing to the meat of these hearings.

Mr. WATKINS. I don't mind being ruled out but I——

Mr. Moss. I ruled out Mr. Stuckey and I have ruled out Mr. Keith and I intend to rule out any other member at this point.

Mr. WATKINS. I will accept your ruling under protest.
Mr. Moss. You must accept my ruling.
Mr. WATKINS. I don't have to accept it. I accept it under protest.
Mr. Moss. The gentleman will suspend any further interruptions.
Mr. WATKINS. I will be happy to retire.
Mr. Moss. That is a matter for the gentleman's choice.
Mr. WATKINS. If you desire I will be happy to retire.
Mr. Moss. I do not desire the gentleman to make a further spectacle of himself.

Mr. Cohen, you will address yourself to the question propounded on section 22(d).

Mr. COHEN. Yes, Mr. Chairman, if I may I would like to assure Mr. Watkins that I would be glad to supply any additional information now, later, at any time, because I do want him to be satisfied that the problems he has are met. But I want to go back to the point I was making.

I did call the industry in. We did discuss this problem. They felt that the lifting of section 22(d) would be disastrous for the funds and those who sell them. They said that the dealers who wanted to sell mutual funds would stop buying them from principal underwriters and purchase them at cut prices in the market, and that mutual fund sales charges would thereby be driven down to a point where most dealers would stop selling them at all. In other words, they said the force of competition would reduce the charge.

They said that as a consequence the existing system of distribution would break down, the underwriters would be unable to make enough sales to offset redemptions, and the funds would be thrown into a net redemption status, and ultimately wither away.

Now we believed then and we still believe that many of these fears are very much exaggerated. In fact, there are funds from time to time, and there are funds right now, that are in a net redemption status, and it hasn't been a disastrous situation for the industry. Nevertheless, in reviewing the situation, the Commission was persuaded that the industry was seriously concerned.

On the other hand, there is another school of thought that believes that the repeal of section 22(d) would not really accomplish the full-scale competition that its proponents suggest, because they say that even if they were free, mutual fund dealers would not cut prices. The absence of competition has gotten to be a way of life in the mutual fund industry. And I am talking about competition in the sale of the shares of particular funds.

Of course, insofar as you are dealing with the integrated organizations—and a representative of one of them proudly stated, and I am not quarreling with that, that his group accounts for 15 percent of the industry—they sell only through their own representatives, and obviously there is no competition there. And it was urged that repeal of section 22(d) might also favor those fund managers who deal through the so-called integrated or captive sales organizations rather than through dealers.

Section 22(d) does not really have much effect on these organizations, because as I have indicated, there cannot be any real retail competition where there is only one retailer. There was apprehension that if

22(d) were repealed, and the general level of loads received by dealers declined somewhat, the captive organizations would have an advantage over independent dealers in recruiting salesmen.

Now there are ways in which this advantage could be offset to some degree, for example, by requiring those funds to make their shares available to independent dealers at the same price, that is asset value, that is asset value plus distribution charge, on which their own sales force operates, and authorizing the Commission as well to make appropriate rules to be sure that the charges levied by these integrated or captive sales organizations would be in line with those that prevail generally in a situation where independent dealers are making markets in a regime of free competition. Both of these steps it should be noted would of course involve some regulation of sales load, at least for a segment of the industry.

It was also felt that repeal of section 22(d) probably would not benefit or might not benefit, maybe the word "probably" is too strong, the small unsophisticated investors to whom sales are made on a door-to-door basis, since such sales are made in an atmosphere in which price competition is avoided whenever possible. Thus, perhaps the very people most in need of protection would not get it from a repeal of section 22(d), which would primarily benefit the more knowledgeable and sophisticated investor who might be in a position or be advised to shop around.

We accordingly proposed regulation rather than repeal of section 22(d), because of the uneven effects that such repeal probably would have had.

Mr. KEITH. Mr. Chairman.

Mr. MOSS. Mr. Keith would like to query you further in order to clarify the response you are making to this question on section 22(d).

Mr. COHEN. Yes, sir.

Mr. KEITH. I do not believe that there has been much argument before this committee in connection with any recommendation to the effect that we seriously consider amendment of section 22(d). I understand as a matter of election you and the industry did reach agreement in this respect.

Mr. COHEN. No, sir.

Mr. KEITH. No?

Mr. COHEN. Not on this 22(d) issue. I am not sure that I understand your point. But I must say this, Mr. Keith. It was suggested to me the question should be answered. A member of the committee asked that I deal with this particular problem just as you did a little while ago, so that there is considerable interest, and I understand that Professor Wallich, if no one else, raised this issue. I understand further that this issue has been raised by other people, and I assume that it is before the committee.

Indeed, in the memorandum which is dated May 1, 1967, which I sent to each member of the committee, together with our technical statement on the bill, I listed among the possible alternatives which we had considered, or which had come to our attention, the possible repeal of section 22(d).

Now I have tried in a few minutes to explain the reaction of the industry as we understand it, and the reasons which led the Commis-

sion to depart from what I think in many other respects seems to be a most attractive way of dealing with this problem. In other words, we took on a real burden by recommending 5 percent so everybody could say we are price cutting and so forth and so on and price fixing, and so on, rather than taking the easier route and saying let's lift 22(d) and let's allow free competition to play, or at least to have a chance. We undertook the more difficult task, and we still feel that that is the appropriate route.

Mr. KEITH. If I may in an effort to give further discussion on alternative methods of achieving a better buyer's market, more choice, more economy of scale in the field of management, there are it seems to me at least three or maybe more ways in which people can buy mutual funds.

We have the no-load funds and we have internally managed funds, and we have relatively new developments, at least new to this committee, of those individuals who want to buy into a particular stock, such as the "Quimby Plan."

Of course, the law permits that kind of choice to the individual, and in order to open up that market, that may be somewhat under a cloud by reason of statute, isn't it possible to encourage variation in load by permitting no-load funds to advertise other than by "tombstone" ads?

Mr. COHEN. No-load funds have substantial and in many respects greater liberty in the area of advertising than do other corporations selling securities to the public. In 1954——

Mr. KEITH. In selling mutual funds to the public?

Mr. COHEN. Yes, sir. You are talking about no-load funds now. Maybe I misunderstood your question.

Mr. KEITH. I am talking about no-load funds.

Mr. COHEN. I will try to answer your question this way. In 1933, and we are now talking about the Securities Act of 1933, the Congress decided that the protection that the investing public needed was to have presented to it, in convenient form, a document which we call a prospectus, which contains the information deemed relevant and material to an informed judgment.

The Congress determined, based on hard experience, and many, many examples, some of which I have locked up in a curio case, to do away with the type of advertising that occurred in the 1920's and in the early 1930's.

So the Congress decided that the only advertising that should be permitted in the newspaper, subject to the reprinting of the full prospectus, or as we allowed later on, a newspaper prospectus, which is a kind of a summary of it, that they be permitted to have a very simple advertisement, which has gotten to be called a "tombstone" advertisement.

Mr. KEITH. Excuse me. We have got just a few minutes left today.

Mr. COHEN. Yes, sir.

Mr. KEITH. And maybe you can just disabuse me of my logic by accounting for section 10.

Mr. COHEN. Section 2(10)?

Mr. KEITH. Section 10(d), the ifs, "If such an investment company, open end company," and so forth, no sales low charged on securities——

Mr. COHEN. That is another issue, sir. I thought you were talking about tombstone advertising.

Mr. KEITH. I am talking about ways to open up the market. It goes on to say "No sales promotion incurred by such company"——

Mr. COHEN. Let me deal with that. First I will finish the other very shortly by saying that in 1954 the matter of advertising——

Mr. KEITH. But there is nothing in the statute under which they operate today that inhibits their more aggressive selling of load funds. They can today if they want to finance sales or promotion expenses. I am talking about the 1940 act, is that not pertinent today?

Mr. COHEN. Is that not pertinent today?

Mr. KEITH. Yes.

Mr. COHEN. I am not sure. Pertinent to——

Mr. KEITH. Is it not pertinent to this discussion?

Mr. COHEN. I am not sure that that is pertinent to the discussion on this bill, but I think it is a pertinent question.

Mr. KEITH. My question was how can we open up this thing to get the competitive forces at work to give the buyer more choice?

Mr. COHEN. Well, I think the industry has indicated that, that they have to pay salesmen increasing amounts in order to——

Mr. KEITH. I realize that.

Mr. COHEN. I understand that.

Mr. MOSS. I think that what Mr. Keith is asking, Mr. Cohen, is the only device available to increase the attractiveness of the sales field itself to the salesmen, or is there available a legal method for more aggressively advertising these funds, bringing them directly to the attention of the prospective buyers?

Mr. COHEN. There is a basic issue. I am sorry, I misunderstood the question. I think the Congress was concerned very seriously with dilution of the interests of people who are in a fund.

Now for this reason section 10(d), and I am now aware of a particular provision to which you refer, provides that there shall be no promotion expenses incurred by the registered company, because to the extent that they became more aggressive and they used the assets of the fund, this would be a fee paid by existing shareholders, who have very little interest or concern with whether or not other people come into the fund. This is the reason for that provision.

Now normally to the extent that there is promotion, and there is considerable promotion by some in the no-load area, it is paid for by the investment adviser out of the fees that he gets for managing the fund, and there is a very simple business reason for it. The larger the fund, the larger the fee. So it is a business expense which he is prepared to assume.

But if you should impose that charge on the fund itself, you may be asking people who bought 10 years ago, 5 years ago, 3 years ago, to pay the part of the promotion for the benefit of the investment adviser to bring other people into the fund.

Mr. KEITH. I suppose what it leads to is internal management of mutual funds.

What we are trying to do on this committee is allocate economies of scale through the present scheme of things, the free enterprise system, full disclosure, true competition, and not to set up, if possible, a pater-

nalistic agency to accomplish the same objective, if our corporate structure in its present capability can do the job, and what Mr. Watkins was trying to do was to find out whether or not the States couldn't do the job. You don't feel that they can.

Later on we are going to discuss whether or not the NASD could regulate this thing. Apparently you have——

Mr. COHEN. Mr. Keith——

Mr. KEITH. You can answer those comments later on. You have already to some extent.

Mr. COHEN. I haven't, sir.

Mr. KEITH. You have given us an awful lot to chew on. Let me give you a little bit.

Mr. COHEN. I will be glad to, but I am trying to be helpful, Mr. Keith. The only way I know how is by speaking to these points.

Mr. KEITH. Well, getting to the alternative method of internal management, if your proposal became law, these management companies, their profits as a result of that decision would immediately be subject to, I would suspect, a reduction to 10 percent instead of an average of 40 percent return on stockholders' equity. Internally managed funds wouldn't have to live with that law. You say they would. How would they do so? Would they go internal?

Mr. COHEN. There were a lot of questions there, Mr. Keith, and I hope you will bear with me. I will try to deal with them.

First of all, to correct a misimpression, we never proposed that the NASD be elected to undertake this job. That came about as a result of a question put to the NASD by the chairman of the Senate Banking and Currency Committee, in which they replied that they would be willing to undertake it under certain conditions specified in the letter they submitted to him.

It is my impression that the bulk of the mutual fund industry does not want the NASD in the picture. They don't want the NASD to fix sales charges. They don't want the SEC to be involved. They don't want the courts to be involved. They don't want the Congress to do anything about it. But they want the price-fixing arrangement.

Now coming back to your question about internalization and things of that sort, our recommendations are rather mild. In the area of management fees we are only asking that they be subject to a standard of reasonableness, and certainly a person who is asking other people to give him their money to manage should be subject to a test of reasonableness, not by the Commission but by the courts, and that we remove from the statute the protections put into the statute by the Congress, to the extent that they have really become a shield for the manager rather than a protection for the investor. That is what it is. Now there are many ways in which this could be achieved. Internalization——

Mr. KEITH. The shield for the manager existing until the Congress put that in the statute to provide a little bit more protection for the shareholder.

Mr. COHEN. That shield did not exist before, no, sir. If I understand what the law is, because of this requirement for unaffiliated director approval and shareholder approval of these contracts, instead of a test of reasonableness, the test is corporate waste; that is, it must be excessively excessive or unreasonably unreasonable. Normally, the

shareholders do not pass on the contracts that a commercial corporation makes with anyone, no matter how big it is, that is not normal corporate practice, but the courts said this is unusual, this is unique. You have got situations here that do not exist in the normal corporate setup. We are trying to restore the statute to what the Congress intended to achieve in 1940.

Mr. KEITH. My point was that in 1940 the shareholders did not have that protection because of this built-in conflict. We thought that there should be unaffiliated directors.

Mr. COHEN. Precisely.

Mr. KEITH. You maintain it hasn't worked as well?

Mr. COHEN. You put it very well, Mr. Keith. Because of those provisions the Congress put in to protect the investor, it has worked out in a way to his detriment.

Mr. KEITH. On balance, I am not sure I agree with you. On balance the funds have been well managed—they have done well—and people have chosen this vehicle as an investment.

Mr. COHEN. Mr. Keith, they have done well. There is no question about that. Very few people have not done well in these rising markets, and you have had testimony before you by very prominent economists who raise some serious questions as to the value of the investment management. We are not questioning that. We are saying they are entitled to a fee. The only thing we are saying is, it should be a reasonable fee. Let me answer your question, though.

Mr. KEITH. All right, if you would. The question I really want to ask is this: Is there any end result that would accrue by reason of the enactment of your recommendations that would cause these funds to move to an internally managed operation, getting the apparent benefits of size, that, for example, Massachusetts Investment Trust gets?

Mr. COHEN. Mr. Keith, I am glad you put it that way. There is nothing in the bill to prevent it, and when I was here before I made a special point to urge upon the committee that in marking up a bill, it not do anything which would prevent that possibility, that possible mutualization, that possible internalization, so that they would operate in the way a normal corporation is operated, or by means of a service corporation owned by the funds. I agree with that 100 percent, and I think we all must be sure that that would not happen. I think Mr. Loomis has something to add to that.

Mr. LOOMIS. I agree with all that, but I wouldn't want the record to appear that our bill is going to require them to internalize—because I don't think it will—that will be a choice that they will have to make.

Mr. COHEN. As a matter of fact, we abandoned that choice even though it was an attractive one, and settled on what I considered to be the most conservative, the most modest proposal possible.

Mr. MOSS. Mr. Stuckey, you have some questions now?

Mr. STUCKEY. Thank you, Mr. Chairman.

Let's go back to management. You stated in your memorandum that the dollar cost to the individual for management fees is relatively small and has little impact upon his investment decision. If this is so, why does he need protection against excessive management fees? And what do you mean by "relatively small"? That is, relative to what?

Mr. COHEN. Mr. Stuckey, he is a stockholder in a corporation. He has joined with many other stockholders. He is not seeking individual advice and he doesn't get it, and all the services that attend it. He is in a company that grows. Now, any normal corporation that has big buying power has the ability to obtain its supplies, its services, or what-have-you, on a basis which takes into account its size. All we are saying here is that in this area those common, everyday rules ought to apply to an equal measure.

Mr. STUCKEY. Then you back up your statement that the dollar cost to the individual for his management fees is relatively small.

Mr. COHEN. The amount to the individual investor, depending on his investment, may be small, but I don't know what you mean by "relatively."

Mr. STUCKEY. You said in your memorandum that it was.

Mr. COHEN. Yes; yes. What I am saying is it varies in a particular case. But it is small to him. But that is like saying "What difference does it make if we pay the president of the corporation $10 million when there are 10 million shares outstanding? It is only a dollar a share."

Mr. STUCKEY. If he is worth it, I don't see why you shouldn't. I think you should. I don't think there is anything wrong with that.

Mr. COHEN. If he is worth it; I am sure the court will take that into account in determining whether or not the fee is reasonable or unreasonable.

Mr. STUCKEY. All right. Now, has the Commission found any malpractices in the field of management fees?

Mr. COHEN. Our whole purpose here, Mr. Stuckey, is that we believe by looking at every other situation that we think at all comparable, that there are malpractices. The charges here are excessive.

Mr. STUCKEY. Have you found any malpractices in the field of management fees?

Mr. COHEN. They are excessive, and to that extent it is a malpractice.

Mr. STUCKEY. They are all?

Mr. COHEN. Sir, I didn't say they all are. I said that there are fees here that are excessive. I think if you look at the exhibits introduced into the record by the industry, and look at the range of fees charged for management of similar size funds, I think there is a reasonable question raised whether one at one end is unreasonably high, whether the other one is unreasonably low. They both may be all right, depending on the facts of that particular case.

Mr. STUCKEY. So you stated, as I understand it, that there are malpractices in the field of management fees now?

Mr. COHEN. In the sense I use it, we do believe that the fees are excessive in a number of areas; yes, sir.

Mr. STUCKEY. So why hasn't some court action been taken?

Mr. COHEN. Because of the standard which Judge Friendly pointed out. Now, so far as the Commission is concerned, we have to deal with section 36, and if you will forgive me, I want to explain that.

Section 36, in its original form, was a criminal statute. The industry objected to that in 1940, and almost at the last minute—I don't remember whether that is precisely correct—the statute was changed to make it a civil statute. But they used the words, "guilty of gross abuse of

trust," not "abuse of trust," which is the standard any court goes by, not "abuse of fiduciary obligation," but "gross abuse of trust." This industry says they don't want to be viewed in any other light except in a gross abuse of trust, a very strange position.

Mr. STUCKEY. So, isn't this right? You have found no malpractices in the management field?

Mr. COHEN. We have not brought any actions under section 36 attacking the fees.

Mr. STUCKEY. All right. Now, do you think that a prominent disclosure of management fees—let's take for example, say, on the cover page of a prospectus, would this adequately inform the prospective investor?

Mr. COHEN. It might. It probably does adequately inform him. But the Congress decided that that was not enough in this area. If disclosure was enough, there was no need for the 1940 act to begin with, but let me point to one thing, Mr. Stuckey.

In every other area of inside dealing, if a director wants to sell 10 shares of stock, any stock, to the fund, it is forbidden, even though it may only amount to $1,000, or $100. It is forbidden, and he has to apply to the Commission. The Commission has to find that it is fair and reasonable; that it involves no overreaching, and that it is consistent with the policies of the company and the purposes of the act.

But here, you have the same conflict, much more insidious, far more far reaching, and there is no standard for review.

Mr. STUCKEY. So you are saying that a prominent disclosure of the management fee on the cover of a prospectus would not adequately inform the prospective investor?

Mr. COHEN. Yes, sir; we are saying that, obviously. We wouldn't be here otherwise.

Mr. STUCKEY. So, in effect, you are saying that an individual investing in a mutual requires more protection against paying excessive charges than an individual, say, purchasing, say, a kitchen stove on the installment plan?

Mr. COHEN. Yes, sir; and that was the Congress decision in 1940.

Mr. STUCKEY. So you are saying he is ignorant——

Mr. COHEN. I didn't say he is ignorant, sir. I said he needs more protection.

Mr. STUCKEY. I don't see this.

Mr. COHEN. Well, the point is, in the 1933 act, there are all kinds of provisions for giving information, but the Congress decided in 1940 that it needed more, that it needed regulation of this industry, because of the built-in conflict, because these people sit astride these funds, and run them, and they sit on both sides of the table. It isn't a situation of an ordinary corporation where you are held accountable to your own shareholders, and you don't have any other interest.

When you have another interest, then you are accountable in a court.

Mr. STUCKEY. We are getting off in another area. Now, do the mutual fund shareholders have any way of knowing what the profits of the management company are?

Mr. COHEN. They don't have it now, except indirectly in those situations where the management company is a publicly owned company and the information may be found in the public files somewhere.

Let me answer that fully. Some years ago, the Commission thought that this might be a way of dealing with the problem. And it made a proposal. Now, you fellows have heard some explosions here, but they don't compare with the explosion that occurred at that time.

Mr. STUCKEY. Do you think if they disclosed this in a prospectus—what effect do you think it would have?

Mr. COHEN. It wouldn't change our views.

Mr. STUCKEY. No, or the person purchasing the mutual fund.

Mr. COHEN. I don't know that it would.

Mr. STUCKEY. Would this be a material disclosure?

Mr. COHEN. I don't know that it would, because if someone is sold these funds face to face, however he buys them, because he wants to buy this vehicle, and this is the charge that the traffic will bear, he doesn't have many alternatives.

Mr. STUCKEY. I want to ask one last question, because I know time is running out. The answer can be submitted later if there is no objection, to save some time. But I have not seen where this is different from an ordinary corporation.

I have seen where the disclosure is there. I don't see that it is different from any other business but we come back to the 5 percent, which as you said is the great burden in setting the 5 percent.

I have yet to see in writing or in any testimony how you arrived at 5 percent. This is something I would like to see. How did you come up with 5 percent? Why not 5.32, or why not 6.8?

Mr. COHEN. I will answer that as I did when I appeared here before. We examined into the charges made elsewhere in the industry. And, by the way, under the 1934 act, as it relates to transactions on the stock exchange, the test is reasonableness. In the 1934 act, as it relates to transactions in the over-the-counter market, except for mutual funds, the test is reasonableness. And they even have a rule in the NASD that these charges should be fair.

But in the context of sections 22 (b) and (c), and 27, no one has felt that there was sufficient authority to deal with this problem. In looking at all of those situations, we found that the charges for mutual funds were very substantially higher than the charges for the acquisition of securities in many other areas.

That was an important consideration.

But we also looked at the fact that that is not the end of the expense that the investor bears. He is in the fund. Every time they change a security, he has to pay the brokerage. He has to pay a management fee, and we thought that in our recommendation we were arriving at a figure which was generous in relation to other situations.

We examined the cost involved in distributions, where the underwriters assume a market risk on a security of comparable quality, so to speak, and we found that that was lower than 5 percent. So we arrived at 5 percent.

Mr. STUCKEY. So you have stated, and your figure is different from 8.5, but you say the prevailing sales charge is 9.3 percent, and you wish to see it cut to 5 percent.

Mr. COHEN. Yes, sir.

Mr. STUCKEY. Presumably, you think then that 5 percent is a reasonable sales charge.

Mr. COHEN. We do.

Mr. STUCKEY. I assume, then, if 5 percent is considered reasonable, why not 9.3 being considered grossly excessive?

Mr. COHEN. I would like to explain that because that question is one that I have troubled myself about for many, many years. In section 27, which relates to contractual plans, the Congress fixed the maximum sales load at 9 percent. Now, I might also mention that was the first time, under the 1940 act, the Congress undertook to fix a maximum price in the Federal securities laws.

I think 22 (b) and (c) read in terms of unconscionable and grossly excessive charges, with some residual authority in the Commission.

The NASD has felt, and through the years the Commission has felt, that in the context of that statutory situation which I have explained, it would not be possible to establish that that standard of unconscionable or grossly excessive could be applied to the run-of-the-mill charge which approximated the figure which the Congress itself fixed in section 27.

Mr. STUCKEY. This is the point of our whole question; 9.3 is just about double the 5 percent which you say is reasonable, a complete doubling or close to it, which to me would constitute excessively excessive, and yet this has never been proven. The courts have ruled that it was not.

Mr. COHEN. No, sir; it has never been before the courts.

Mr. STUCKEY. I thought there were three cases.

Mr. COHEN. No, sir.

Mr. Moss. I think that the point that the chairman was attempting to make, in saying that the fee on the front end load, the Congress set it at 9 percent, and because of that action by the Congress, it was felt that they could not sustain the burden of proving that that fee applied to the non-front-end load was excessively excessive or unreasonably unreasonable.

Mr. STUCKEY. But the point that I still maintain is that the courts themselves do have the right to determine whether it is excessively excessive.

Mr. Moss. Dr. Jennings yesterday and Judge Friendly both pointed out the virtual impossibility of proving that. They felt it was of little value to protect the investor.

Mr. COHEN. Mr. Stuckey, there have been no cases that I am aware of where that issue has been before the courts. The cases involved management fees.

Now the only way the Commission could attack it, subject to this 22 (b) and (c) thing, as I have explained, is by bringing an action under section 36 charging these people with being guilty of a gross abuse of trust, and the Commission has felt in the context of the statutory situation that it was not authorized to bring that type of action.

Mr. STUCKEY. There have been no actions?

Mr. COHEN. There have been none; no, sir. We have initiated none.

Mr. STUCKEY. Thank you.

Mr. Moss. Mr. Chairman, on page 5 of your statement you said, "The simplest way to deal with conflicts of interest would be to eliminate them."

You said, "This can be done by requiring the mutual funds to be internally managed."

But then you say, "The Commission rejected this approach as being too drastic."

However, on pages 27 and 29 of your statement, you point out that mutual fund advisory fees are excessive: "The unaffiliated director does not work to reduce fees," and that "Internally managed funds have lower costs of advice."

On the basis of the argument which you yourself made, I cannot see your statement that the abolition of the outside advisory service is too drastic. In other words, I think that your reasoning would lead to the conclusion that such a proposal would not be too drastic, as you set forth in your statement.

Mr. COHEN. It would be very difficult to argue against it. I will try to explain the situation.

Mr. Moss. Is this not exactly what Congress did in 1935?

Mr. COHEN. Yes, sir.

Mr. Moss. In connection with public utility holding companies?

Mr. COHEN. Yes, indeed.

Mr. Moss. Why haven't you made that recommendation here, then?

If you would like to reflect upon that one very carefully, it is not intended to entrap you, you can prepare a written response and I will supply you with the question.

Mr. COHEN. I will be glad to do so; yes, sir.

Mr. Moss. In fact, I have a number of questions which will be proposed to you in writing, and I will restate now the situation as we close this phase of the hearings.

The members of the committee have the right to propound questions to any of the witnesses in writing. The witnesses are to respond within 2 weeks. That means 2 weeks from today, the questions which are received should be answered and the answers back in the hands of the committee for inclusion in the record.

Mr. COHEN. We appreciate the opportunity very much.

(The following letter was received by the committee:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., November 7, 1967.

Hon. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance,
House of Representatives, Washington, D.C.

DEAR MR. MOSS: I am pleased to enclose the Commission's replies to the 8 questions which you submitted to us under cover of your letter of October 24.

Please do not hesitate to call on me if you wish any further information in connection with this legislation.

Sincerely,

MANUEL F. COHEN, *Chairman.*

[Enclosures]

1. It is, of course, true that the simplest and the most effective way of dealing with a conflict of interest problem is to eliminate the conflict by removing its fundamental causes. For this reason, one might conclude that the external advisory system ought to be abolished and that investment companies should be precluded from contracting out the most essential parts of their work to separate entities controlled by the same people who are in practical control of the investment companies. It may be useful, therefore, to outline the countervailing considerations which led the Commission to conclude that it would be desirable to recommend the more conservative approach taken in H.R. 9510.

Internalization might not benefit the shareholders of newly created funds. These investors sometimes benefit from the external system because an adviser to such a fund often is willing to invest his time and energy to build the fund and therefore may spend more to run the fund then he receives from it in advisory income in the first years. He does so in the hope that as the fund grows it will provide an advisory income that will be adequate enough to compensate for the deficits incurred when the fund was small and to provide an opportunity for capital gain. Since the prospect of the entrepreneurial profits that can be earned under the external system once a fund reaches a certain size is a principal incentive for the formation of new funds, there is some reason to believe that forced internalization might inhibit the formation of new funds.

Consideration should also be given to the fact that many mutual fund management companies are now publicly held. Since most of those companies derive substantially all of their income from their profitable advisory relationships with the investment compaines that they serve, compulsory internalization would have a greater impact than our recommendation on the interests of the many thousands of public investors who hold stock in mutual fund management companies.

It should be pointed out, however, that management company shareholders are a much smaller and a more sophisticated group than mutual fund shareholders.[1] The prospectuses covering public offerings of shares in mutual fund management companies have made it very clear that under the Investment Company Act the relationship between an investment adviser and its investment company client is always terminable at the investment company's election.

The Commission believes that it is important to achieve a fair balance of all the interests affected and that every effort should be made to find an approach which would deal effectively with problems of mutual fund investors in a manner that would have the least possible adverse effect on the mutual fund management business. We think that section 8 of H.R. 9510 and 9511 embodies such an approach.

The Public Utility Holding Company Act of 1935 prohibits registered holding companies from supplying goods or services to the operating companies in their systems. It permits holding company subsidiaries or "mutual service companies", to furnish such services, but only under contracts to be "performed * * * at cost fairly and equitably allocated * * *." It should be noted in this connection that there are today large, successful funds and fund complexes which are operated either by their own staffs or by service subsidiaries owned by the funds themselves.

While there are similarities between the role of the service company in the utility business of the pre-Holding Company Act era and the role of the management company in the mutual fund business of today, the two situations are not precisely parallel. In the mutual fund case, the advisory business is generally the central function and main source of profit of the management company, which usually has no substantial stock interest in the funds which it advises. To compel internalization by law would be to wipe out the value of management company securities, substantial quantities of which are held by public investors.

In the utility situation, on the other hand, the service function was only a part of the holding companies' business. Their principal assets were the securities of the operating companies, and their principal source of income was generally the return on those securities. Their dissolution resulted in the distribution to the holding company shareholders of operating company securities, which very often had a market value higher than that of the surrendered holding company securities.

Moreover, while the conflicts of interest engendered by external management in the mutual fund industry directly affect the interests of four million mutual fund shareholders, the conflicts of interest endemic to the public utility holding company structures of the pre-1935 era inflicted direct injury on almost every consumer of gas or electricity in the United States. The artificially inflated costs of production that the service company device inflicted on the operating companies affected the customers as well as the security holders of those companies. State and local regulatory bodies were unable to protect consumers because they

[1] At the end of 1966 the publicly held management companies had about 67,000 shareholder accounts, less than 1% of the approximately 7,000,000 shareholder accounts that the mutual funds had at that same time.

usually lacked jurisdiction over the service companies. Drastic action was imperative to protect consumers and to promote maximum utilization of the technical advances in the transmission of electricity.

Of course, nothing in the bill precludes the voluntary internalization of investment company management through the acquisition of the management companies by the investment companies they manage on a basis fair to all interests concerned. With respect to compulsory internalization, however, the Commission believes the view expressed at page 149 of Public Policy Implications of Investment Company Growth is still valid:

"The Commission believes that an alternative to the more drastic solution of compulsory internalization of managements should be given a fair trial. That alternative lies in applying to management compensation the standard of reasonableness that the Act applies to other transactions between investment companies and their affiliated persons. The Commission believes that this regulatory approach also can resolve the problems that exist in the area of investment company management compensation. If it does not, then more sweeping steps might deserve to be considered."

2. The Commission clearly has the power to require comparative disclosure of the relative management costs of different investment media. Under the Securities Act of 1933 the Commission can insist on the disclosure of all material facts. Alternative investment media and a comparison between their costs and those of the particular investment medium offered are plainly material. Thus the question is not one of power but of the wisdom of exercising it.

Although the Commission has on previous occasions considered the possibilities, it has concluded that the advantages of comparative disclosure in investment company prospectuses were not clear and, in any event, there were doubts that the benefits would offset the administrative difficulties this type of disclosure would entail.

To begin with, the advantages would be limited. Management costs are significant. But even to the most cost-conscious investors they are by no means the most significant cost of mutual fund investment. From the small investor's point of view the sales load is by far the principal cost of a mutual fund investment. Most mutual fund investors are small investors, and the 8.5 percent sales load that they normally pay is almost 19 times an advisory fee rate of one-half of 1 percent. Thus, comparative disclosure in the management cost area would have to be complemented by comparative disclosure in the sales charge area.

Disclosure of comparative cost would also require that disclosure of management and acquisititon charges be supplemented at least by reference to relative benefits, for example, investment performance. The performance of a fund is undoubtedly as material to an informed investment decision as are operating costs and sales charges.

This would present additional difficulties. There would be a question whether the comparison should deal with all alternative investment media, or all mutual funds, or to funds of a particular type, or whether it should refer to some stock market average. There would also be the problem of assigning a particular fund to a particular category, since the dividing lines among the various categories of funds are not always clear.

It has been argued that there is a risk that adequate disclosure in this area would be self-defeating because it would require mutual fund prospectuses to become, in effect, treatises on investment in general. Encyclopedic prospectuses would of course be useful in certain situations but they might become totally unreadable to the average investor. Prior attempts by the Commission to add only a portion of such disclosure to proxy statements and prospectuses have been met with these and other arguments.

After 34 years of experience there are still many problems in trying to determine what is needed in order to give a fair portrayal of a particular security. To determine what constitutes a fair presentation in relation to the attributes of all other competing investment media would present infinitely greater and more difficult problems.

However, as noted at the hearings, we are not satisfied that the range and value of present disclosure is adequate. Our staff has been reviewing these requirements to determine whether and the extent to which improvements can be made which will assist investors without imposing unnecessary or impossible

burdens on issuers. This effort will be expedited as much as possible within the limitations of our resources.

3. Prior to the introduction of H.R. 9510 on May 1, 1967, the Investment Company Institute made two proposals to the Commission as alternatives to the provisions of the Bill relating to advisory fees. The Institute's first alternative would have increased the number of independent directors required to be on an investment company board of directors from 40 percent to a majority of the board. This requirement, for the most part, reflects the existing industry practice. In addition, the Institute suggested an elaboration of a relatively minor part of our own legislative proposals, which would merely tighten the standard for the independence of unaffiliated directors by requiring them to be "disinterested" persons. Although we believe that enactment of this proposal would be helpful in certain other areas of investment company affairs, unaffiliated directors cannot effectively deal with problems in the advisory fee area. As we have previously pointed out, the problem is not the unwillingness of the unaffiliated directors to deal with the questions, it is their inability to do so.

After the Commission rejected this proposal as wholly inadequate, the Institute submitted a second "alternative" to the Commission's proposal. This alternative would have required that a majority of the independent directors of an investment company, before approving an advisory contract, find in the exercise of their business judgment that the compensation payable to the adviser is reasonable. Under this proposal the Commission would be precluded from taking any enforcement action. Only the investment company or a fund shareholder would be able to institute a suit alleging that the directors had "abused their business judgment." However, a court could not render judgment for the plaintiff on the ground that the fee was unreasonable, even if it found that the evidence supported that conclusion, unless the plaintiff proved by "clear and convincing evidence" that the director's approval of the advisory contract was a "clear abuse of business judgment." This proposal may have the virtue of recognizing the elementary principle that the fiduciary's fees must be reasonable and that it is a proper function of the courts to enforce this obligation. But it would, in fact, hamstring the courts in the exercise of this traditional role by preventing them from acting unless the evidence was "clear and convincing" that the approval of directors was "a clear abuse of business judgment."

This proposal would have the effect of putting the directors, particularly the unaffiliated directors, on trial, rather than the fees. It would neither be fair to the directors nor lead to an effective enforcement. As a practical matter, it would provide an even greater degree of insulation from judicial scrutiny than now exists as long as the defendants could show that the directors had gone through the ritual prescribed by careful counsel to wrap the fees in the protective cloak of "business judgment."

For these reasons the Commission did not and does not now believe that the proposals of the Institute constitute a viable alternative to the provisions of H.R. 9510 with respect to advisory fees.

We do not believe that Mr. Robert Haack, in his statement to the Subcommittee on behalf of the New York Stock Exchange intended to advance proposals different from those that had been advanced by the Institute and rejected by the Commission. Mr. Haack did, however, describe the Institute's proposal as permitting the courts to enforce a standard of reasonableness if it found an "abuse of business judgment." Such a proposal, like the Institute's proposal, would still put the directors, rather than the fees, on trial. It also implies that the directors are in a position to make a "business judgment" in approving an advisory contract when in fact they have no realistic alternative but to accept the contract offered by the adviser. But the Institute's proposal did not go even that far. It would preclude enforcement of the standard of reasonableness unless the court could find "clear and convincing evidence", which showed a "clear abuse of business judgment."

4. In his letter of October 18, 1967, Deputy Attorney General Warren Christopher, comments principally on the Commission's recommendations for a 5 percent limitation on the basic sales charge for mutual fund shares and for a standard of "reasonableness" to be applied to advisory fees.

With respect to sales loads, the Department of Justice notes that the proposed 5 percent limitation is not inconsistent with the basic concept of the Investment

Company Act of 1940, under which the investment company industry is already subject to a substantial degree of regulation. The Department suggests, however, that in addition to the proposed limitation on sales loads, the Congress consider modifying the resale price maintenance provisions of Section 22(d) of the Act, either by repealing that section altogether or by amending it to provide that no sales could be made "at a price higher than the current public offering price." The Department notes that the principal objections that have been made to the proposals for repeal of Section 22(d) are that it would enable knowledgeable investors to purchase mutual fund shares at lower prices than unsophisticated investors, and that it might give "captive sales forces" an undue advantage over independent dealers in selling fund shares. These objections, of course, were fully exposed before your Subcommittee in our statement, and were among the reasons why the Commission recommended the 5 percent limitation rather than the repeal of Section 22(d).

We believe, of course, that retail price competition can result in great benefits to consumers in the mutual fund area, as it has in so many other areas. While we have not recommended the repeal or substantial modification of Section 22(d), therefore, we concur in the suggestion of the Department of Justice that the Congress give careful consideration to this proposal in conjunction with our proposal for a 5 percent limitation, in view of the very different situation which exists in the industry today as compared with the situation which existed when the Investment Company Act was adopted in 1940.

With respect to advisory fees, the Department of Justice suggests that the Congress consider vesting in the Commission, rather than the courts, the authority to determine the reasonableness of management fees, or in the alternative requiring the Commission to report to the courts on the merits of any private lawsuit instituted under the standard of reasonableness.

Our suggestion to vest this authority in the courts, rather than in the Commission, reflected our confidence in the ability of the courts to adjudicate this type of question, which Judge Friendly made clear in his testimony before your Subcommittee. We also wished to make clear that the Commission was not seeking any kind of "rate-making authority" in this area.

The suggestions of the Department of Justice are designed to assure consistency of regulation and to avoid proliferation of court action. We recognized the importance of both of these objectives in our statement and in our legislative proposal, which specified certain factors to be taken into account in determining whether a particular fee is reasonable, and which provides for Commission intervention as a matter of right in private suits to enforce the standard of reasonableness. As Judge Friendly noted in his statement, there is a spectrum of alternative techniques for achieving these objectives, including those suggested by the Department of Justice. While we have not sought authority for the Commission to determine the reasonableness of advisory fees or a requirement that the Commission submit a report to the court in all cases, we would of course undertake the responsibility if the Congress decided that either of these modifications in our proposal is desirable.

5. Mr. Ronald Lyman testified regarding the difficulties he would have under the bill in getting non-affiliated directors. This argument was not advanced by Loomis-Sayles Mutual Fund, Incorporation ("Loomis-Sayles") in the application it filed for a Commission order enabling it to continue operating with a Board of Directors more than 60 percentum of whose members are affiliated with its investment adviser. As a no-load fund, Loomis Sayles has not been required to have such a Board of Directors and the company felt it should not change its Board simply because it proposed to sell its shares at a sales load overseas.

Mr. Lyman testified that no-load mutual funds would be hard put to find enough willing and qualified persons to serve as non-affiliated or disinterested directors because of the sharply increased responsibility and risk imposed on them by the bill. He stated that it is likely that many individuals who might now be willing to serve as non-affiliated or disinterested directors would be unwilling to do so under the new law.

In contrast, the application filed by Loomis-Sayles did not refer to this matter. Loomis-Sayles stated that unless it received an exemption under the Investment Company Act, it would be necessary to either increase the size of

its Board of Directors or to obtain the resignations of certain of the affiliated directors or a combination of these two alternatives. Loomis-Sayles represented that, because the board consisted of 14 directors, it did not believe that it would be in the best interest of its shareholders to increase the size of its Board of Directors. Furthermore, Loomis-Sayles represented that it did not believe that it would be in the best interests of its shareholders to remove from the board persons who had been selected on the basis of their ability and experience. The Commission granted Loomis-Sayles the order requested on October 25, 1967. It should be noted however, that the sole effect of the Commission's order is to permit Loomis-Sayles to avoid changing the make up of its Board of Directors while offering and selling its shares in Germany at a 7½ percentum sales load.

6. The Securities and Exchange Commission is studying the impact of investment companies and other financial institutions on the securities markets.

We are now attempting to expand our knowledge in this area by requesting more frequent reports from investment companies and by inaugurating a program to collect similar data for other institutions. The data presently available on institutional trading in individual securities are for the most part quarterly data on net changes in investment company portfolios. As part of its surveillance activities the Commission on certain occasions has made specific inquiries into investment company trading in particular securities.

CONCLUSIONS

As to the impact of mutual funds on the markets for particular securities, the Commission's Report on Public Policy Implications of Investment Company Growth noted their tendency to concentrate their portfolio holdings in relatively few securities. Indeed, in recent years many of the largest funds have reduced the number of different stocks in their portfolios. Such concentration increases the power of fund managers to affect the market in particular securities by their investment decisions. Further, as the irregular and relatively infrequent transactions of institutions in sizable blocks of securities become increasingly significant and the relative importance of individuals' 100- and 200-share orders declines, the auction markets find it increasingly difficult to maintain the high liquidity, depth and continuity which they traditionally have sought to achieve. Correspondingly, particular issues which mutual funds trade becomes more susceptible to sharp, sudden and erratic price fluctuations.

Our study of the quarterly data shows that there is some apparent relationship between changes in the balance of investment company holdings and the direction of price movements for individual stocks. Investment company impact appears greater on these stocks most heavily purchased on balance than on the stocks most heavily sold on balance.

One might logically infer that trading by investment companies causes this relationship. Others might argue, however, that investment companies have a tendency to buy stocks that are rising in price and sell stocks that are declining in price. On the basis of the quarterly data available it is impossible to reach any definitive answer.

The relationship of investment company transactions to stock market prices is strongly influenced by the behavior of the market as a whole. When the market goes down sharply (e.g., the second and third quarters of 1966) both the most heavily purchased and the most heavily sold stocks perform more poorly than when the market goes up (e.g., the fourth quarter of 1966 and the first quarter of 1967).

The Commission's case studies of trading in individual securities over short periods of time show that in some cases professional managers tend to have the same pertinent information and a similar ability to analyze it. Accordingly, their investment decisions tended to be homogeneous.

A fund manager that is determined to sell a large block quickly may not be able to find institutional purchasers willing to buy the block at something close to the last price. If the block cannot be sold near that price to the public through a secondary distribution, there is a strong possibility that the stock's price will decline sharply. This in turn may cause other fund managers to dispose of or lighten their holdings of the stock, causing the stock's price to plummet downward.

TABLE I.—NUMBER OF COMMON STOCKS HELD AND AVERAGE MARKET VALUE PER HOLDING AMONG THE LARGEST MUTUAL FUNDS,[1] DEC. 31, 1963, TO DEC. 31, 1966

Name of mutual fund	Number of common stocks held			Average market value per holding		
	1963	1966	Percent increase (decrease)	1963 (in thousands)	1966 (in thousands)	Percent increase (decrease)
1. Investors Mutual, Inc.[2]	134	111	(17.2)	$10,010	$12,997	29.8
2. Massachusetts Investment Trust	100	103	3.0	18,381	19,204	4.5
3. Wellington Fund, Inc.[3]	106	133	25.5	9,285	8,802	(5.2)
4. Dreyfus Fund, Inc.	133	157	18.0	3,716	8,778	136.2
5. United Accumulative Fund	140	71	(49.3)	3,986	10,980	175.5
6. Affiliated Fund, Inc.[4]	155	154	(.6)	5,273	7,264	37.8
7. Fundamental Investors, Inc.	117	87	(25.6)	6,305	11,582	83.7
8. Insurance Securities Trust Fund	95	138	45.3	12,154	7,637	(37.2)
9. Fidelity Trend Fund, Inc.	77	113	46.8	1,200	6,715	459.5
10. Investment Co. of America	114	125	9.6	2,360	4,051	71.6
11. National Investors Corp.	133	129	(3.0)	2,780	4,141	48.9
12. Hamilton Funds, Inc.[5]	106	81	(23.6)	2,844	4,776	67.9
13. Television-Electronics Fund, Inc.[4]	107	94	(12.1)	3,062	3,786	23.6
14. Chemical Fund, Inc.	53	55	3.8	5,585	7,117	27.4
15. George Putman Fund of Boston	107	87	(18.7)	2,085	2,881	38.2
16. Dividend Shares, Inc.[4]	99	99	----------	3,238	3,307	2.1
17. State Street Investment Corp.	105	122	16.2	1,901	2,550	34.1
18. American Mutual Fund, Inc.[4]	76	96	26.3	2,232	2,929	31.2
19. Boston Fund, Inc.[6]	107	87	(18.7)	2,044	2,163	5.8
20. Financial Industrial Fund, Inc.[3]	110	83	(24.5)	2,169	3,553	63.8

[1] Includes the 20 largest funds managed by different investment advisers.
[2] As of Sept. 30, 1963, and 1966.
[3] As of Nov. 30, 1963, and 1966.
[4] As of Oct. 31, 1963, and 1966.
[5] As of Oct. 31, 1963.
[6] As of Jan. 31, 1964, and 1967.

INCREASE IN CONCENTRATION

Table I, infra, compares, for 20 of the largest funds, the number of common stockholdings and their average market value at the end of 1963 and 1966. Between 1963 and 1966 ten of these funds increased the number of common stocks in their portfolios, while nine decreased the number, and in one case the number remained unchanged. During this period of fund growth 18 of the 20 funds increased the average value of each holding. In part these increases are due to rising markets. In most instances, however, funds are placing more money in individual stocks than they have done in the past. For instance, Fidelity Trend Fund, whose assets increased from $106.1 million in 1963 to $983.1 million in 1966, increased the number of common stocks in its portfolio from 77 to 113, an increase of almost 47 percent. In 1963, however, the average amount held of each stock was only $1.2 million and in 1966 this had increased more than 4½ fold to $6.7 million. The largest mutual fund, Investors Mutual Inc., during this period decreased the number of common stocks in its portfolio 17 percent and increased its average holding about 30 percent.

STUDY OF QUARTERLY DATA

Table II shows that in the second quarter of 1966 the NYSE Composite Index decreased 5.09 percent. The price of all ten of the most heavily purchased stocks fared better than this index, and the prices of seven out of ten of the most heavily sold stocks fared worse than this index. The median of the most heavily purchased stocks increased 10.0 percent, while the median of the most heavily sold stocks decreased 6.7 percent.

TABLE II.—INVESTMENT COMPANY PURCHASES AND SALES OF COMMON STOCKS, QUARTER ENDING JUNE 30, 1966 [1]

	Shares (in thousands)			Number fo funds		Total volume [2] (in thousands)	Investment company activity as a percent of total volume		Price				Percent net change
	Bought	Sold	Net	Bought	Sold		Purchases	Sales	Open	High	Low	Last	
Top 10 purchases (dollar value):													
Trans World Airlines	1,456	35	1,421	35	4	4,022	36.2	0.9	$69¾	$101	$69¾	$89⅝	+28.5
International Business Machines	163	8	155	53	3	811	20.1	1.0	344	374¾	332½	350½	+1.9
Eastern Airlines	529	82	447	21	5	4,834	10.9	1.7	93¼	123¼	93¼	104⅞	+12.7
Minnesota Mining & Manufacturing	487	88	398	12	4	958	50.8	9.2	66⅜	79⅜	65¼	73⅛	+11.9
SCM Corp	344	21	323	5	2	7,634	4.5	.3	57½	91⅞	56¾	77⅝	+38.9
Eastman Kodak	199	7	192	14	3	1,170	17.0	.6	93¼	140	93¼	128½	+4.7
Burroughs Corp	357	31	326	7	2	2,934	12.2	1.1	64⅝	78⅝	60¾	70⅜	+9.5
Reynolds Metals	362	17	345	12	2	1,167	31.0	1.5	58	66¼	52	54¾	−4.4
Polaroid Corp	184	54	130	16	7	2,466	7.5	2.2	147	156⅞	113¼	142	−2.7
United Gas Corp	362	38	324	11	4	1.077	33.6	3.5	50¼	60⅛	50	55⅛	+10.5
Top 10 sales (dollar value):													
General Motors	79	669	589	9	26	4,321	1.8	15.5	93⅞	95⅜	80	80½	−14.2
American Airlines	86	406	323	7	9	1,870	4.5	21.9	69¾	82	64¼	75⅛	+7.7
Pennsylvania Railroad	165	566	401	8	8	1,529	10.8	37.0	61½	71½	53	57⅞	−5.9
Ford Motor	7	513	505	1	11	3,521	.2	14.6	50⅜	52¼	45	45⅝	−10.0
Reynolds Tobacco	7	590	582	1	8	1,400	.5	42.1	40⅜	41⅛	37⅛	37¼	−7.7
American Tobacco	9	520	511	1	5	1,167	8.8	44.6	36⅛	36⅛	33⅛	33⅝	−6.9
Goodyear Tire & Rubber	116	435	319	7	6	1,432	8.1	30.4	44¾	53⅜	43	50⅞	+13.7
Dow Chemical	18	201	183	3	9	882	2.0	22.8	71⅜	77½	65⅝	66	−7.5
FMC Corp	55	404	349	3	5	821	6.7	49.2	38⅞	43¾	34½	35⅞	−3.8
Boeing Co	305	478	172	18	14	3,737	8.2	12.8	76⅛	91	61	71⅛	−6.5

[1] NYSE composite index:

Mar. 31, 1966	48.37
June 30, 1966	45.91
Net change	−2.46
Percent Net change	−5.09

[2] Over-the-counter volume, NYSE and major regional exchanges.

Sources: "Vickers Guide to Investment Company Portfolios."

TABLE III.—INVESTMENT COMPANY PURCHASES AND SALES OF COMMON STOCKS QUARTER ENDING SEPT. 30 1966 [1]

	Shares (thousands)			Number of funds		Number of funds holding	Total volume [2] (thousands)	Investment company activity as a percent of total volume		Price				Percent net change
	Bought	Sold	Net	Bought	Sold			Purchases	Sales	Open	High	Low	Last	
Top 10 purchases (dollar value):														
Burroughs Corp	574	72	502	15	4	50	3,300	17.3	2.2	$70 7/8	$88 1/2	$66 1/8	$77 1/4	+9.8
Minnesota Mining & Manufacturing	717	245	472	13	4	79	1,285	55.8	19.1	75	84	61	77 1/4	+4.6
Raytheon Corp	683	53	630	10	3	22	3,742	18.2	1.4	44 1/4	56 7/8	39 5/8	52	+20.9
Sperry Rand	1,147	34	1,113	9	4	54	9,999	11.5	0.3	27	33 5/8	26	27 1/2	+3.3
Cities Service	850	348	501	14	7	56	2,164	39.3	16.1	44 3/8	57 1/2	44 1/8	46 1/4	+3.1
Columbia Broadcasting System	341	32	309	12	2	62	807	42.2	4.0	55	62	48 5/8	55 3/8	+0.2
Uniroyal	626	215	411	6	3	28	978	64.0	22.0	40 3/4	48 3/4	34 1/2	40 3/8	−0.3
Amerada Petroleum	253	23	229	5	3	42	386	65.5	5.9	80 7/8	82	69 1/4	72	−10.6
Sinclair Oil	348	99	249	15	5	68	902	38.6	11.0	61	69 1/2	56 1/8	60 7/8	−0.2
General Precision Equipment	239	2	237	5	1	16	2,073	11.5	0.1	52	66 1/2	46 1/2	62 3/8	+21.7
Top 10 sales (dollar value):														
General Motors	17	1,069	1,052	3	23	170	4,870	0.34	21.9	80 7/8	86 1/4	70 1/4	74 7/8	−7.0
Pennsylvania RR		811	811		13	42	2,172		37.3	57 3/4	59 7/8	42	45 3/4	−21.0
Chrysler Corp	7	1,017	1,010	3	12	77	4,714	0.1	21.4	39 1/8	41 3/4	33 1/2	35 1/8	−9.9
Boeing Co	189	883	694	5	19	75	3,012	6.3	29.3	72 1/2	71 7/8	49 3/4	49 3/4	−30.8
United Aircraft	190	635	445	20	11	80	1,474	12.9	43.1	85 1/4	78	66 3/4	73	−15.4
Standard Oil of New Jersey	39	506	466	11	10	164	2,498	1.6	20.2	69 1/8	71 3/4	59 3/4	63 3/8	−7.8
Xerox Corp	146	311	165	21	20	137	3,127	4.7	9.9	246	264 3/4	154 1/2	154 1/2	−37.1
General Electric	69	396	328	10	13	111	1,824	3.8	21.7	106 3/8	110 3/4	80	85	−19.9
Syntex Corp	118	469	351	11	9	71	3,216	3.7	14.6	92 7/8	94 1/4	63 1/8	72 5/8	−21.4
Union Carbide	100	550	450	7	8	77	1,741	5.7	31.6	59 1/2	73 3/8	49 7/8	50 1/4	−14.5

[1] NYSE composite index:

June 30 1966	45.91
Sept. 30 1966	41.30
Net change	−4.61
Percent change	−10.04

[2] Over-the-counter volume, NYSE and major regional exchanges.

Source: "Vickers Guide to Investment Company Portfolios."

TABLE IV.—INVESTMENT COMPANY PURCHASES AND SALES OF COMMON STOCKS, QUARTER ENDING DEC. 31, 1966

	Shares (thousands)			Number of funds		Number of funds holding	Total volume [2] (thousands)	Investment company activity as a percent of total volume		Price				Percent net change
	Bought	Sold	Net	Bought	Sold			Purchases	Sales	Open	High	Low	Last	
Top 10 purchases (dollar value):														
American Telephone & Telegraph	1,116	----	1,116	26	0	130	6,020	18.5	----	$51¼	$57⅝	$50½	$55	+7.3
International Business Machines	119	35	84	26	7	224	786	15.1	4.5	318	386	289½	371¼	+16.9
Sperry Rand	973	11	962	12	3	67	7,185	13.5	0.2	28⅛	30⅝	20⅝	29¾	+8.2
Kaiser Aluminum	579	9	570	14	1	47	760	76.2	1.2	33	45¼	30⅜	42⅛	+28.6
Travelers Corp	622	8	614	11	1	73	----	----	----	29	39¾	27⅞	38⅜	+32.3
Gulf Oil	515	122	393	12	5	108	1,754	29.4	7.0	56	60⅞	54	59⅛	+5.6
Standard Oil (New Jersey)	381	42	338	15	3	165	2,515	15.1	1.7	63⅝	71	61⅛	63¼	−0.2
McDonnell	704	3	701	11	2	45	1,632	43.1	0.2	23⅝	33¾	20½	30⅛	+28.9
Bristol Myers	374	1	373	5	1	52	921	40.6	0.1	45	58¾	43⅛	55	+22.2
General Dynamics	557	131	425	11	2	45	1,451	38.4	9.0	41	54	39	48⅛	+17.4
Top 10 sales (dollar value):														
Fairchild Camera	157	390	233	13	10	40	6,087	2.6	6.4	134½	136	96⅞	116⅝	−12.3
Tidewater	67	350	283	4	6	14	707	9.5	49.5	59	75	55⅛	73⅛	+25.0
Boeing	69	455	387	8	12	63	3,840	1.8	11.8	53	67¾	44½	65⅝	+28.7
Eastern Air Lines	116	434	318	10	12	65	2,993	3.9	14.5	70½	85½	53	76⅞	+11.6
Goodyear Tire & Rubber	21	588	567	3	10	53	1,436	1.5	40.9	47¼	50⅝	40¾	41½	−11.7
Magnavox	60	666	605	6	9	53	3,739	1.6	17.8	50	50⅝	36¾	36⅞	−25.1
Zenith	23	468	445	3	17	53	2,206	1.0	21.2	57	57⅝	46⅛	47½	−15.7
General Motors	22	342	321	8	11	165	5,398	0.4	6.3	75⅛	76½	65⅝	65⅞	−12.0
Pan American World Airways	229	584	354	8	14	69	3,856	5.9	15.1	50⅛	60⅝	40	54¾	+ 8.1
Motorola	69	277	207	7	14	54	1,527	4.5	18.1	113	121½	91¾	93	−13.3

[1] NYSE composite index:

Sept. 30, 1966	41.30
Dec. 30, 1966	43.72
Net change	+2.42
Percent change	+5.9

[2] Over-the-counter volume, NYSE and major regional exchanges.

Source: "Vickers Guide to Investment Company Portfolios."

TABLE V.—INVESTMENT COMPANY PURCHASES AND SALES OF COMMON STOCKS, QUARTER ENDING MAR. 31 1967[1]

	Shares (thousands)			Number of funds		Number of funds holding	Total volume[2] (thousands)	Investment company activity as a percent of total volume		Price				Percent net change
	Bought	Sold	Net	Bought	Sold			Purchases	Sales	Open	High	Low	Last	
Top 10 purchases (Dollar value):														
American Telephone & Telegraph	977	118	860	22	6	141	5,731	17.0	2.1	$541½	$623/4	$541/8	$60	+9.1
International Business Machines	152	45	107	23	11	233	698	21.8	6.4	370	461	362	432	+16.3
Eastern Air lines	595	140	455	11	8	62	2,828	21.0	4.9	80	1101/2	753/4	987/8	+28.6
Xerox Corp	180	50	130	16	11	145	1,233	14.6	4.0	201	1971/4	2893/4	2801/8	+47.9
Raytheon	569	36	533	12	3	38	1,927	29.6	1.9	527/8	695/8	49	68	+28.3
Control Data	680	80	600	8	2	27	4,252	16.0	1.9	333/8	331/2	581/2	565/8	+75.6
Gulf & Western Industries	667	42	625	11	6	43	6,044	11.0	0.7	341/8	305/8	597/8	531/4	+55.5
Litton Industries	318	10	307	14	2	80	1,478	21.5	0.7	833/4	80	1063/4	1041/4	+28.1
Fairchild Camera	254	4	250	6	2	42	2,922	8.7	0.1	1183/4	2011/4	1097/8	1841/4	+58.3
Ampex Corp	1,124	172	952	9	4	36	4,495	25.0	3.8	241/2	323/4	223/4	311/2	+31.2
Top 10 sales (dollar value):														
Standard Oil of New Jersey	48	1,281	1,232	7	24	155	6,288	0.7	20.4	633/8	603/8	663/4	64	+ 1.2
General Motors Corp	69	563	494	5	10	155	4,153	1.7	13.5	673/4	801/8	671/2	761/4	+15.7
Northwest Airlines	44	355	311	5	15	90	1,220	3.6	29.1	119	1103/4	1351/8	1203/8	+ 1.1
Avon Products	37	402	365	5	9	65	1,017	3.6	39.6	811/4	851/4	1001/2	993/4	+23.1
Delta Air Lines	5	295	290	2	13	54	819	0.6	36.0	1171/2	1323/8	115	1221/8	+ 3.3
Merck and Co	15	343	328	4	10	55	1,045	1.4	32.8	761/2	835/8	74	811/2	+ 6.2
National Airlines	57	341	283	4	12	38	1,157	4.9	29.5	881/4	931/2	72	85	− 0.6
Magnavox Corp	69	702	633	3	11	41	3,863	1.8	18.2	383/8	441/8	361/4	363/4	− 0.3
Texas Instruments	94	267	173	10	11	58	1,410	6.7	18.9	1021/2	1351/8	991/2	1321/2	+31.7
Reynolds Metals	61	401	340	5	8	69	1,907	3.2	21.0	51	583/8	463/4	531/4	+6.2

[1] NYSE composite index:

Dec. 30, 1966	43.72
Mar. 31, 1967	49.52
Net change	+5.80
Percent net change	+13.27

[2] Over-the-counter volume, NYSE and major regional exchanges.

Source: Vickers Guide to Investment Company Portfolios."

As shown in Table III in the third quarter of 1966 the NYSE Composite Index decreased 10.0 percent. The prices of nine out of ten of the most heavily purchased stocks had above average appreciation, while seven out of ten of the most heavily sold stocks declined more than this index. The median of the most heavily purchased stocks increased 3.2 percent, and the median of the most heavily sold stocks decreased 17.7 percent.

In the fourth quarter of 1966, as shown in Table IV, at page 8, the NYSE Composite Index increased 5.09 percent. Price increases for eight out of ten of the most heavily purchased stocks were greater than the rise in the index; six out of ten of the most heavily sold stocks showed price declines greater than the index. The median price increase of the most heavily purchased stocks was 71.2 percent; the median of the most heavily sold stocks decreased 11.8 percent.

In the first quarter of 1967, as shown in Table V, the NYSE Composite Index increased 13.2 percent. Nine out of ten of the most heavily bought stocks had price increases which exceeded this figure, seven out of ten of the most heavily sold stocks fell short of it. The median price of the most heavily purchased stocks increased 29.9 percent; the median price of the most heavily sold stocks increased only 4.7 percent.

There is a tendency for different stocks to be in the top ten stocks purchased or sold on balance in each quarter. Among the stocks purchased, 32 different stocks appeared with only seven of them appearing in more than one quarter. One of these appeared in three quarters. Of the stocks sold on balance in each of the four quarters, there were 31 different stocks, three of which appeared in two quarters, one in three quarters and one in all four quarters. Within these four quarters, five stocks appeared among the most heavily purchased in one quarter and among the most heavily sold in another quarter. In two of these cases the stocks appeared among the stocks most heavily purchased or sold more than once. This seems to indicate that institutional favor and disfavor shifts rapidly from stock to stock.

The greater the percent of volume which is accounted for by investment companies, the greater is the relationship to the change in the price of the stock. This is shown by Table VI which presents an analysis of the price movement of the 50 stocks most widely held by investment companies shown in Table VII. As can be seen from Table VI, the greater the percent of volume accounted for by the balance of investment company trading the greater the likelihood that the stock's price change, relative to the index, will be in the same direction as the

balance of investment company trading. Considering all 50 stocks, 30 out of the 50, or 60 percent, did better or worse than the averages according to the balance of investment company trading. Of the 34 stocks where the net purchase or sales balance exceeded 10 percent of volume, 23 stocks, or 68 percent, did better or worse than the averages according to the balance of investment company trading. However, when only those 14 stocks in which the balance of investment company trading exceeded 20 percent of total volume are considered, 12 out of the 14 stocks, or 86 percent, showed such an impact.

TABLE VI.—EFFECTS OF INVESTMENT COMPANY TRADING ON 50 STOCKS MOST HEAVILY HELD BY INVESTMENT COMPANIES QUARTER, ENDED MARCH 31, 1967 [1]

ALL 50 STOCKS

22 stocks in which investment company purchases exceed investment company sales		28 stocks in which investment company sales exceed investment company purchases	
12 stocks did better than market averages	10 stocks did worse than market averages	10 stocks did better than market averages	18 stocks did worse than market averages

34 STOCKS IN WHICH BALANCE OF INVESTMENT COMPANY VOLUME EXCEEDED 10 PERCENT OF TOTAL VOLUME

15 stocks in which investment company purchases exceed investment company sales		19 stocks in which investment company sales exceed investment company purchases	
9 stocks did better than market averages	6 stocks did worse than market averages	5 stocks did better than market averages	14 stocks did worse than market averages

14 STOCKS IN WHICH BALANCE OF INVESTMENT COMPANY VOLUME EXCEEDED 20 PERCENT OF TOTAL VOLUME

5 stocks in which investment company purchases exceed investment company sales		9 stocks in which investment company sales exceed investment company purchases	
4 stocks did better than market averages	1 stock did worse than market averages	1 stock did better than market averages	8 stocks did worse than market averages

[1] Market average used is the NYSE composite index which increased 13.27 percent.

TABLE VII.—THE 50 LARGEST COMMON STOCKHOLDINGS OF INVESTMENT COMPANIES AS OF MAR. 31, 1967

Stocks	Market value (in millions of dollars)	Number of funds holding	Number of shares held Mar. 31, 1967 (in thousands)	Shares held as a percent of outstanding stock	Net increase (decrease) in number of shares held Dec. 30, 1966, to Mar. 31, 1967 (in thousands)	Total volume [1] Jan. 3, 1966, to Mar. 31, 1967 (in thousands)	Net increase (decrease) in number of shares held as a percent of total volume January to March 1967	Price (in dollars)				Percent net change
								Open	High	Low	Last	
International Business Machine Corp	$1,477	233	3,970	7.1	234	699	33.48	370	461	362½	451	21.5
Polaroid Corp	677	133	3,715	235	(65)	2,422	(2.68)	160	200¾	154¾	182⅛	14.7
Xerox Corp	615	145	2,196	103	137	1,233	11.11	201	289¾	197¼	280⅛	41.8
Eastman Kodak Co	530	124	3,602	45	44	1,081	4.07	128½	150¾	125¾	147	15.1
Texaco, Inc	477	142	6,276	46	(199)	1,294	(15.38)	70¾	78¾	68	76	6.3
Northwest Airlines, Inc	413	90	3,434	375	(361)	1,220	(29.59)	119	135⅛	110¾	120⅜	1.2
Gulf Oil Corp	374	109	6,059	59	228	1,446	15.77	59¼	64¼	57¾	61¾	4.4
American Telephone & Telegraph	353	141	5,875	11	912	5,573	16.36	54½	62¾	54⅛	60	9.1
Minnesota Mining & Manufacturing	329	83	3,565	67	(106)	924	(11.47)	78½	93½	75	92¼	18.3
International Telephone & Telegraph	325	89	3,637	174	57	1,150	4.96	72½	89⅞	72½	89¼	22.9
Standard Oil Co. of New Jersey	296	155	4,620	21	(1,231)	6,053	(20.34)	63⅜	66¾	60⅜	64	1.2
General Motors Corp	292	155	3,831	13	(509)	4,065	(12.52)	67¾	80⅛	67½	76¼	15.7
General Telephone & Electronics	278	108	5,413	58	(219)	1,804	(12.14)	45	55	44⅛	51⅜	13.5
Avon Products, Inc	276	65	2,771	97	(353)	1,029	(34.31)	81¼	100½	76	99¾	23.1
Burroughs Corp	263	60	2,206	270	(24)	1,975	(1.22)	87¼	124⅞	80⅞	119¼	35.9
Columbia Broadcasting System	260	72	3,807	179	72	1,041	6.92	61⅞	75¾	59½	68⅜	11.2
Litton Industries, Inc	252	80	2,421	115	329	1,478	22.26	83¾	104¼	80	104¼	28.1
Mobil Oil Corp	243	105	5,332	53	(233)	1,633	(14.27)	45½	49½	42⅝	45½	(2.7)
International Nickel of Canada	236	111	2,589	87	(86)	594	(14.48)	87¾	92¾	83⅜	91¼	4.0
United Air Lines, Inc	235	78	3,066	185	232	2,001	11.59	61	81⅝	57¾	76½	25.4
Royal Dutch Petroleum Co	228	81	6,288	65	266	1,539	17.28	33⅝	37¾	33¼	36¼	9.4

Amerada Petroleum Corp	222	50	2,383	187	106	847	12.51	77	97½	76½	99	21.2
American Airlines, Inc	221	65	2,492	277	173	1,638	10.56	69⅜	94	65⅝	88½	28.3
General Electric Co	209	96	2,468	27	(184)	2,355	(7.81)	90½	94¼	82½	84⅞	(4.1)
Westinghouse Electric Corp	205	71	3,793	101	135	1,814	7.44	47⅜	58½	46⅜	54⅛	13.4
Gillette Co	199	69	4,006	141	398	1,280	31.09	41¾	50⅜	40¼	49¾	19.2
Continental Oil Co	185	64	2,527	112	(174)	791	(22.00)	70⅞	74¼	65½	73¼	3.5
Ford Motor Co	182	71	3,556	32	(76)	1,887	(4.03)	39½	52¼	39½	51¼	33.1
Trans World Airlines Inc	179	66	2,139	236	(121)	1,916	(6.32)	74¼	90¾	72	83¾	13.8
Sperry Rand Corp	179	74	5,429	175	936	6,763	13.84	30	36	28⅛	33	10.9
Radio Corp. of America	176	72	3,805	63	428	2,861	14.96	43	51½	42⅝	46⅜	8.5
Louisiana Land & Exploration	175	35	2,862	158	(80)	363	(22.04)	58⅞	63	52¾	61⅛	3.8
Texas Instruments	174	58	1,312	122	(213)	1,410	(15.11)	102½	135⅛	99½	132½	31.7
Sinclair Oil Corp	171	73	2,242	147	(8)	1,503	(.53)	62½	76⅛	61¼	76⅛	22.3
Bristol Myers Co	171	59	2,464	98	133	638	20.85	53¾	69½	52⅝	69¼	25.9
Pan American World Airways	170	64	2,556	159	(181)	3,743	(4.84)	55½	73½	51⅞	66⅝	21.7
Eastern Air Lines	170	62	1,715	299	504	2,828	17.82	80	110½	75¾	98⅞	28.6
Boeing Co	168	68	2,035	104	101	2,760	3.66	68¾	86⅜	61¾	82½	25.7
Anaconda Co	161	78	1,938	177	(210)	1,281	(16.39)	80⅝	93⅜	78¼	83¼	4.1
Delta Air Lines Inc	158	54	1,295	203	(364)	819	(44.44)	117½	132⅜	115	122⅞	3.3
Merck & Co	158	55	1,295	60	(306)	1,045	(29.28)	76½	83⅜	74	81½	6.2
Shell Oil Co	157	43	2,372	39	62	749	8.28	60¼	67⅜	59¾	69	10.0
Aluminum Co. of America	155	59	1,819	85	188	797	23.59	78⅜	90¾	74¼	85¼	8.8
United Aircraft Corp	146	69	1,604	136	(9)	1,577	(.57)	79⅝	96½	77¾	91⅛	11.6
Atlantic Richfield Co	145	54	1,611	142	(147)	603	(24.38)	86¾	92	83⅛	90	3.7
Standard Oil of California	144	71	2,412	30	(181)	1,774	(10.20)	60⅝	64⅜	57¾	59⅞	(.4)
Deere & Co	143	43	1,942	132	(180)	552	(32.61)	68⅞	75½	66⅛	73¼	8.5
Kerr McGee Corp	142	35	1,382	209	(12)	377	(3.18)	80½	108⅝	80⅛	102⅝	26.9
Lockheed Aircraft	142	71	2,195	197	(184)	1,154	(15.94)	62	65¼	55⅞	64⅝	(2.5)
Southern Co	141	58	5,064	103	68	877	7.75	28¾	30¼	27⅛	27¾	(3.9)

[1] Over-the-counter volume, NYSE and major regional exchanges.

Source: Vickers Guide to Investment Company Portfolios.

On one day in November 1966, well over a half a million shares of one so-called glamour stock were traded on the New York Stock Exchange. Trading in the issue opened at 126⅜, the high for the day. From that 126⅜ figure the stock skidded down to 105. It closed that day at 106¾, for a net loss of 19⅝, a drop of approximately 17 percent during that single day. Mutual funds bought 1,500 shares (about ¼ of 1 percent of the day's trading) during that day. But mutual funds sold almost a quarter of a million shares (43.5 percent of the day's trading volume) on that day. Among these sales by the funds was one block of 25 thousand shares sold at 115¼, another block of 32 thousand shares sold at 114, and a third block of 137 thousand shares sold at 109½.

In August 1966, one stock opened at 218. By the end of the next day, it had fallen to 200½, for a loss of 17½ points in two days. During that two-day decline mutual funds sold about 135 thousand shares of the stock, approximately 45 percent of the trading volume in the issue during the period. Some funds bought some shares as its price was skidding. But those fund purchases amounted in the aggregate to only 50 thousand shares, just about 17 percent of the volume.

In four trading days in early June of 1966 the price of one corporation's shares fell from 85¾ to 75⅛. During these days mutual funds sold shares equal to about 27 percent of New York Stock Exchange trading volume in the issue during the period. Mutual fund purchases during this period totaled only about 6 percent of the volume. During the ensuing two-week period the funds, as a group, switched to the buy side of the market. Mutual funds bought a total of over 100 thousand shares, more than 23 percent of the volume during the period. Mutual fund sales, on the other hand, amounted to only 65 thousand shares. Bolstered by this buying support from the funds, the price rose 12⅜ points to 87½. Later that month, there was a very sharp reversal of the upward movement. On that day the price dropped 8¾ points on the New York Stock Exchange and an additional 1¾ on the Pacific Coast Stock Exchange so that all the gains of the previous two weeks were almost entirely erased in that one day of trading. Sales by mutual funds that day accounted for 53 percent of total volume compared to mutual fund purchases of less than one-fifth the amount. During the next two weeks the price skidded another 14¼ points to 64½. During that two weeks of sharp declines three funds that had purchased over 100 thousand shares earlier in the month became heavy sellers. From June 24 to July 8, those three funds sold a total of over 170 thousand shares.

During one week and one-half period in September 1966, the price of the stock of one corporation declined 32½ points from 151½ to 119, a decline of more than 20 percent in little more than a week. During this decline aggregate mutual fund sales of over 70 thousand shares accounted for 45 percent of the total trading volume. Mutual funds did some buying during this period. They bought 3 thousand shares, less than 2 percent of the total trading volume.

7. Professor Ernest L. Polk III, Professor of Law at the University of North Carolina, has submitted a statement to the Subcommittee strongly supporting the provisions of H.R. 9510 which would require that advisory fees be reasonable. Professor Folk expressed doubt over the provision of the Bill which would place the burden of proving unreasonableness on the party objecting to the fee. He noted that state corporation law often recognizes that a fiduciary is in a better posture to prove the reasonableness or fairness of his action than the challenger to establish the contrary and suggested that the Bill be changed to place the burden of proving reasonableness upon the defendants.

The Commission recognizes that H.R. 9510 would not go as far as many courts have gone in enforcing the fiduciary obligations of those who manage other people's money and it would not object to a change in the Bill to implement Professor Folk's suggestion. The Commission believes that the Bill, as presently drafted, provides for effective enforcement by shareholders. As Professor Folk pointed out, liberal pre-trial discovery procedures provided for in the Federal Rules of Civil Procedure and comparable procedures in many state courts ease the task of a plaintiff in obtaining the information which is within the knowledge and possession of the defendants. In addition, even where a plaintiff has the burden of proving the allegations of his complaint, many courts place the burden on the defendants of moving forward with evidence which is within their exclusive knowledge or control. For these reasons, we do not believe that placing the burden of proof on the plaintiff would create undue obstacles to prosecution of an action to enforce the standard of reasonableness.

Professor Folk also states that if the Congress is not disposed to place the burden of proving reasonableness on the defendant, the Bill should provide that the burden of proof would not shift to the plaintiff as a result of shareholder ratification but only if the contract is approved by a majority of the disinterested directors who are not interested persons of the investment adviser. We believe that the provisions of the Bill in conjunction with existing requirements of the Investment Company Act achieve substantially the same result. Under the provisions of the Bill the plaintiff would have the burden of proving unreasonableness only if the compensation is paid pursuant to a contract or other arrangement approved or authorized in accordance with the requirements of the Act. The Act now requires that a contract be initially approved by shareholders and thereafter renewed either by shareholder vote or by vote of a majority of the unaffiliated directors. While it is theoretically possible to avoid a vote of approval by directors by submitting for shareholder vote, as a practical matter, the submission to shareholders is accompanied by recommendations of the directors. In this connection, the Bill places a duty on directors of an investment company to request and evaluate the information material to the reasonableness of advisory fees.

8. This proposal would permit the continued existence of mutual fund-holding companies which do not acquire more than 3 per cent of the total outstanding stock of any other registered investment company and which sell their shares at a public offering price which includes a sales load of no more than 1½ per cent. The proposal contains other restrictions, apparently designed to meet the problems of a mutual fund-holding company. The restrictions would permit any registered investment company, the shares of which are held by such a fund-holding company, to refuse to accept for redemption from such a company in excess of 1 per cent of its shares in any 30-day period. The restrictions would also require the fund-holding company to either pass through to its stockholders the right to vote securities held in its portfolio or to vote such securities in the same proportion for and against as all other holders of such securities vote.

The proposal also suggests a "grandfather" clause to permit only the operation of the two fund-holding companies now in existence. This is an unacceptable alternative since, if the restrictions suggested by the proposal are adequate, there would be no need for such a "grandfather" clause. If, on the other hand, the restrictions are not adequate, the public interest would not be served by legislation designed to permit the continued existence of even just a limited number of fund-holding companies. In other words, if the concept is good, there would be no reason to prohibit it at all, and if it is bad, any prohibition should apply across the board.

Upon analysis it is clear that the proposal falls short of solving the problems inherent in a fund-holding company operation. It would not protect against the layering of advisory fees nor would it protect against the layering of administrative expenses. Furthermore, the limitation of a 1½ per cent sales load masks the problem of cumulative sales load that would exist upon the turnover of portfolio securities by the fund-holding company. The proposal also fails to answer problems inherent in a fund-holding company operation such as the fact that restrictions in its investment policy could easily be avoided by investments in mutual funds with contrary investment policies.

The restrictions on redemption and voting suggested in the proposed amendment would themselves create new problems and require special comment.

The restriction on redemption is a recognition of the danger inherent in the threat of potential redemption which would be available to a fund-holding company. A restriction such as that proposed—maximum assured redemption of 1 per cent of a portfolio fund's outstanding securities during any 30-day period—would appear to protect a registered mutual fund whose securities are owned by a fund-holding company from this threat. At the same time, however, it would expose the investors in the registered fund-holding company to undue risk. Assuming, for example, a registered fund-holding company with its assets fully invested in 3 per cent of the outstanding stock of several registered mutual funds, if each of those portfolio funds are obligated to redeem only 1 per cent of their outstanding securities within any 30-day period, only ⅓ of the total assets of the registered fund-holding company would be liquid and available within a period of no more than 30 days, to meet the redemption needs of its own investors.

The proposed restriction with respect to voting rights is also unsatisfactory. The restriction contemplates two alternatives—the registered fund-holding com-

pany would either seek instructions from its own securities holders or vote its portfolio holdings in the same proportion as all other stockholders of portfolio funds vote. The first alternative—involving a pass-through—is not desirable because of the expense and impracticality of repeated proxy solicitations by the fund-holding company. Each time a portfolio fund would solicit its stockholders, the fund-holding company would be required to do the same. A vote in the same proportion, on the other hand, would mean that investors in the fund-holding company would be deprived of an opportunity to exercise their own individual judgment on matters of importance to the stockholders of the mutual funds whose securities are held in the portfolio of the fund-holding company.

Mr. Moss. Mr. Keith?

Mr. Keith. I wonder if we could have Mr. Cohen back to develop this matter?

If there are to be no further public discussions with him, I have had a chance to look over institutional activity for the week of October 24–28, 1966, by the stock exchange, and I wonder if we shouldn't give Mr. Cohen a chance to comment on what further reflections he may have made with reference to the need for some action by this Committee and the Congress in this field.

Mr. Moss. I would, before having you respond, I think it would be very helpful, I would like to ask unanimous consent to include in the record at this point a speech by Commissioner Hugh F. Owens before the Mississippi Valley group of the Investment Bankers Association of America, of Hot Springs, Ark., October, 1967.

Without objection that will be included at this point in the record.

(The speech referred to follows:)

A Regulator's Look at Quick Profit Fever—Some Disquieting Reactions

(Address by Hugh F. Owens, Commissioner, Securities and Exchange Commission, Washington, D.C., before Mississippi Valley Group, Investment Bankers Association of America, Hot Springs, Ark., October 20, 1967)

In 1961, the high level of investor interest in new stock issues led Keith Funston, who was the President of the New York Stock Exchange, to observe that "some would-be investors are attempting to purchase shares of companies whose names they cannot identify, whose products are unknown to them, and whose future is at best highly uncertain."

Both before and since the hot issue market of 1961, there have been investors who have pursued what has been called the "bigger fool" theory of investing. There comes a time, of course, when the latest fool places his sell order only to find that buyers are unwilling to take the stock off his hands at anything approaching the price he recently paid for it. We have little sympathy for the speculator caught in the shakeout. We are concerned, however, for the unwary who are victimized by those who persuade them that the securities markets are a place to make a quick buck.

There are some disturbing signs that we may be on the threshold of another hot issue market. While it has been said that history does not repeat itself, there is once again some evidence that issuers whose names end in the syllables "-tronics" or "-sonics," and other sounds which seem to suggest waves of the future, are being grabbed up by the public at substantial premiums over their offering prices. In a recent instance, a registration statement which became effective on September 5, 1967 contained an Income Statement showing that for the six-month period ending May 31, 1967, the issuer had earnings for the first time in its history. Within 10 days of the effective date of the registration statement, the underwriter and issuer decided to withdraw the offering, cancel all transactions, and bring to the Commission's attention facts that had not previously been disclosed—that the company had operated at a loss in June and July of 1967. By the time this action was taken, the entire offering had been sold out at the offering price of $22.50 per share and active trading was in progress at prices up to $49.00 per share. As a result of the concellation, no securities were delivered and no transactions were consummated.

This case primarily illustrates the adverse consequence that can result from the failure to amend a registration statement in a timely fashion. But it also is an example of the extent to which the public, when prone to speculate, will disregard the considered judgment of both the issued and underwriter as to the approximate worth of the securities.

These matters are all too reminiscent of the experience of six years ago. They suggest that perhaps the only thing we learn from history is that nobody learns anything from history.

This audience, however, need not be reminded that the aftermath of hot issue markets can be disastrous for those in the investment banking business as well as for investors. In most cases, severe losses were sustained by those who invested in and, as of May 8, 1962, still held those hot issues. Following the May 1962 market break, the over-the-counter market went into doldrums from which it is only now—some five years later—beginning to emerge. And in that aftermath, the market for common stock underwritings also suffered for a long time. I am confident that the investment banking community will put its best foot forward in attempting not to encourage another major hot issues market with its inevitable aftermath.

I should make clear that, absent fraudulent and manipulative practices, speculation in the securities markets has never been viewed as unethical or opprobrious. In enacting the Securities Act of 1933 and the Exchange Act of 1934, the Congress recognized, however, that excessive speculation accompanied by considerable price gyrations can be detrimental to the national interest. The Exchange Act established certain controls over securities speculation. In Section 7 it vested in the Board of Governors of the Federal Reserve System power to regulate the amount of credit that may be initially extended on any security registered on a national securities exchange. By adjusting the amount of bank credit available for securities transactions, the "Fed" can attempt to moderate the tempo of price fluctuations in securities markets. Moreover, the Commission is authorized by Section 10(a) of the Exchange Act to prohibit or limit short sales of securities or the use of stop-loss orders. By all counts, these governmental powers and other regulatory authority contained in the Federal securities laws have been used judiciously to maintain public confidence in the securities markets. Our aim over the years has been to exercise the minimum amount of regulation of the securities markets consistent with the public interest and the interest of investors.

Speculation in the securities markets has long attracted the attention of the Securities and Exchange Commission. Until recently, our activities in this respect have primarily been directed toward uncovering situations in which fraud and manipulation are present or in which the absence of adequate information would provide the take-off point for such activity. Most recently, however, we have viewed with great concern certain new developments in the securities markets. One of these developments is short-term trading by a number of professional investment managers. Illustratively, financial institutions effected $11.4 billion of common stock purchases and sales in the second quarter of 1967, a new record. This compares with a quarterly rate of $8.1 billion in 1966 and only $3.1 billion in 1962. In our Report of Public Policy Implications of Investment Company Growth we called attention to the following facts. I will not belabor you with more statistics, but in sum the facts are these:

1. The percentage of all corporate stock held in institutional portfolios has risen at a rapid rate.

2. Among institutions, increases in the stockholdings of investment companies and, most recently, of non-insured pension funds have been striking.

3. Institutions and institutional intermediaries account for a much larger proportion of trading volume in securities than their holdings alone would indicate.

4. Public individuals' share of trading volume has been declining while the institutions' share has been rising.

5. Mutual funds have, by far, the highest portfolio turnover rates of all institutional investors. The latest data indicate that mutual funds as a group are turning over their assets at an annual rate of 35%. Some, including large funds, have a far higher turnover rate. Mutual funds also tend to engage in larger size transactions than other institutional investors and account for a large portion of secondary distributions and other types of block distributions of securities.

Our Report noted further that despite the fact that the assets of mutual funds have grown at a rapid rate in recent years, many of the large funds which have

shared in this growth have reduced the number of different stocks in their portfolios. This concentration increases the power of a few fund managers to affect by their investment decisions the market in particular securities.

Further, as the irregular and relatively infrequent transactions of institutions in sizable blocks of securities become increasingly significant and the relative importance of individuals' 100- and 200-share orders declines, the auction markets find it increasingly difficult to maintain the high liquidity, depth and continuity which they traditionally have sought to achieve. Correspondingly, particular issues which mutual funds trade become more susceptible to sharp, sudden and erratic price fluctuations.

The growth of the funds and other institutions has resulted in substituting the investment decisions of a few professional managers regarding large blocks of securities for the decisions of large numbers of individual investors. Individuals' investment decisions tend to be heterogeneous since there are wide differences in their knowledge of pertinent information, ability to analyze the facts at hand, and in their personal motivations to buy or sell at any particular time. Their buy and sell orders at any one time tend to be in rough balance and their imbalances generally can be handled by the market activity of professionals—specialists and others. Price fluctuations from order-to-order tend to be very close to the previous price.

Professional managers, however, tend to have the same pertinent information and similar ability to analyze it. Accordingly, their investment decisions tend to be homogeneous. A fund manager that is determined to sell a large block quickly may not be able to find institutional purchasers willing to buy the block at something close to the last price. If the block cannot be sold near that price to the public through a secondary distribution, the chances are that the stock's price will decline sharply. This in turn may cause other fund managers to dispose of or lighten their holdings of the stock, causing the stock's price to plummet downward. Here are some examples.

Case 1.—On a single day in the Fall of 1966, well over 500,000 shares of the stock of one of the so-called glamour stocks were traded on the New York Stock Exchange. Trading in the issue opened at the high for the day and then skidded 16%, closing that day down 19⅝ points. Now what did the funds have to do with that? Mutual funds bought 1,500 shares (about ¼ of 1% of the day's trading) of that company during that day. But mutual funds sold nearly a quarter of a million shares (43.5% of the day's trading volume on that day. Among these sales by the funds were one block of 25,000 shares sold at 115¼, another block of 32,000 shares sold at 114, and a third block of 137,000 shares sold at 109½.

Case 2.—In the Summer of 1966, another of the glamour stocks declined 8% or 17½ points in two days. During that two-day decline, mutual funds sold over 130,000 shares of this company, approximately 44.7% of the two-day trading volume in the issue. True, some funds bought the stock as its price was skidding. But those fund purchases amounted in the aggregate to only about 50,000 shares, just about 37% of the massive volume of fund selling.

Case 3.—During seven trading days in the Fall of 1966, another common stock declined 32½ points from 151½ to 119 so that the market value of the stock fell by more than 20% in little more than a week. During this decline aggregate mutual fund sales of about 70,000 shares accounted for 45.15% of the total trading volume. Mutual funds did some buying during this period. They bought 3,000 shares, just about 4% of the number of shares that they had sold.

While these examples are not commonplace, they are no longer unusual. More could be cited.

During the first two decades following the enactment of the Investment Company Act of 1940, investment by the funds for long-term appreciation of capital and income was the name of the game. In recent years, however, many relatively new funds have pursued investment policies which favor rapid turnover of portfolio securities in the light of short-term market movements. Some of these funds have been successful in a considerable number of their longer-established competitors—but by no means all of them—has placed increased emphasis on taking short-term profits and losses.

The reverse side of this short-term trading activity occurs when fund managers decide a stock is a good buy at or about its current price. So they begin to accumulate the stock. This does not mean they purposely act in concert; but as noted, their behavior patterns often tend to be homogeneous and show a striking degree of similarity. As some funds buy this stock—and often the process of

accumulation is slower than that of liquidation—the price of the stock rises on heavy volume. Strong tape action may atract many individual investors and, when the funds stop buying and their purchases are disclosed and publicized, still other investors will buy, reasoning that fund managers' judgement is superior. By this time the fund managers may decide that the stock has no more potential for near-term appreciation and that other stocks are more promising. They sell. If other institutions agree that the stock is overpriced, the funds may dump the stock or a substantial part of it. Now the stock's price may be down to where it was when the funds began to accumulate it. But many individuals will have bought the stock and have losses because of the short-term trading activities of the funds. The fund managers, moreover, may again repeat the process in the same stock or different stocks.

Whether or not such increased trading activity by the funds is properly labeled "speculative," the impact of their increased emphasis on short-term movements has had, as previously noted, and may increasingly have an unsettling impact on the continuity, liquidity and orderliness of the markets in particular stocks. Since some medium-size and a few large funds are engaging in this type of trading, and since they may hold a substantial portion of the floating supply of even the popular and widely held securities, the market impact of this type of trading can be even greater than that of the clearly speculative activities of a small number of unregistered hedge funds and of a few registered funds, whose assets are relatively small, whose disclosed investment methods emphasize speculation.

Hedge funds generally are partnerships of affluent persons which (i) claim an exemption from registration under Section 3(c)(1) of the Investment Company Act based upon the contention that they have no more than 100 securities holders and make no public offerings of their securities, and (ii) use speculative devices such as buying securities on margin, using put and call options, utilizing debt obligations, and short selling.

Numerous reports have been published in the news media of the concern of many in the securities industry, including leaders of its investment company sector, and of others about the impact of short-term trading and speculative activities by certain institutions and, particularly, by investment companies. Some, including the American Institute of Management and Chairman William McChesney Martin, Jr., of the Board of Governors of the Federal Reserve System, have compared such activities and the effects of such activities to the pool operations of the 1920s. Mr. Martin in a recent speech found "disquieting" the trend of certain mutual fund and other institutional managers to measure their success in terms of relatively short-term market performance. He stated:

"Given the large buying power of their institutions, there is an obvious risk that speculative in-and-out trading of this type may virtually corner the market in individual stocks. And in any event, activity of this kind tends to create undesirably volatile price fluctuations."

Mr. Martin concluded:

"The specific responsibilities of the securities industry to those who use its market place may be covered rather well by what used to be called the pursuit of long-run, enlightened self-interest. Customers * * * must not suffer as a result of inside trading or massive institutional speculation * * *. It is the responsibility of the Exchanges and other market organizations to have proper rules and requirements and to see that these standards are scrupulously observed."

If I seem to have zeroed in on investment company managers, let me assure you that we are aware of quickened interest of other institutional managers in the profits to be realized from short-term trading.

The new wrinkle is that today's speculation and short-term trading is being done by professionals—the managers of the so-called "Go-Go" funds and of other institutions. The manager of one of the newer "Go-Go" funds has explained this approach by stating that investment managers are much more technically oriented and that news moves faster. "What used to take two or three years to happen can now take place in a matter of months * * *. [M]arket developments have become so tremendously compressed in time * * *. The values are the same, but the realization of them is much more rapid. This is a much higher risk game than it was two years ago and there is a greater premium on being right." [1] To me, this appears to mean that such professional managers are most

[1] A. Theodore Lyman, Jr., Senior Vice President of Putnam Management Company, the adviser to Putnam Equities Fund, quoted in *Financial World*, September 27, 1967, p. 25.

concerned with trends, not basic values. And I, for one, find it difficult to distinguish this from speculation.

Many of you have been aware of the facts and the problems that I have just related. I am sure, therefore, that your question is what, if anything, has the S.E.C. been doing on this front?

The answer falls into two categories. First, to protect those who invest in mutual funds that engage in short-term trading, the Commission staff has reviewed fund prospectuses. The purpose of this review has been to assure ourselves that those who invest their savings in such funds will have adequate information toward the end that they will not unwittingly risk their money in speculative endeavors.

Secondly, toward the end of helping maintain the general investing public's confidence in the securities markets, we have initiated a fact-gathering program. We must know in greater detail than we now do of the nature, extent and impact of short-term trading activities by institutions.

We have sought and received the cooperation of the Investment Company Institute in obtaining on a monthly basis information showing a breakdown of most of their members' assets by type and the total value of portfolio securities purchased and sold by each member fund. We have proposed the adoption of a new reporting Form N–1Q for registered management investment companies which would make available on a calendar quarter basis information on the gross transactions of such companies in individual portfolio securities and on their securities holdings at the end of each quarter.

Among other matters, we are studying the frequency, nature and impact of mutual funds' trading reversals, i.e., buying and selling or selling and then buying, in individual securities within 20 days. We also are studying the activities of the hedge funds to learn of the type and volatility of securities they trade and the relative short interest of hedge funds in those securities.

The studies made thus far demonstrate the complexity of questions presented by the growing role of institutions in the markets and by the increased emphasis some of them are placing on short-term trading. Our studies emphasize the need for still more detailed information in these and other areas if we are to obtain reliable answers to questions of market impact. There is a need for data which will provide, on a regular basis, a current and continuing picture of the participation of institutions in the markets.

This type of information is indispensable if we are to evaluate the adequacy of exchange markets and other markets for such trading, and if we are to be informed of the effects of such institutional market activity on noninstitutional shareholders and on portfolio company managements. Without such knowledge, it will be difficult for us to know whether changes are necessary in exchange rules and in institutional disclosure requirements or whether legislation in this area is needed.

In addition to information from the exchanges, the Investment Company Institute and the Association of Closed-End Investment Companies, the Commission has been receiving some help in data gathering by institutions over which we do not have regulatory jurisdiction. Among these are the managers of 70 per cent of the total assets of non-insured pension funds, of 82 per cent of the total assets of life insurance companies, and of 60 per cent of the total assets of property and casualty insurance companies.

Analysis of the impact on the markets of institutional trading generally, and in particular short-term institutional trading, will require continuing and additional information from securities industry associations and institutional managers. I believe that these institutions will respond to Chairman William McChesney Martin's call for enlightened self-interest. I am hopeful that they will use their resources to supplement those of the Commission, and other governmental bodies that have an interest in these problems, in the compilation, analysis and evaluation of the information necessary to a better understanding of the impact of the changing nature of institutional trading activity in the securities markets.

Mr. Moss. Now would you respond to Mr. Keith?

Mr. COHEN. I understand that my letter to you, Mr. Chairman, and the letter to Chairman Staggers, in which you raised these issues some time back, are in the record, and I won't try to repeat all of that.

We are continuing our studies, our investigations. We are concerned, and one of our sister agencies has recently taken some actions in this general area.

I think the question, if I heard it correctly, was as to the general desirability of initiating a study. I think it would be desirable to have a study, to collect and collate the various bits of information. I should say that we do have considerable information, but we don't have as much information as we would like to have.

Even more important perhaps than such a study, which should be a thorough one, I think it is desirable to establish as best we can a continuing flow of information, because the institutionalization of the market is continuing apace, and in my opinion will continue at a great pace. So that the idea of a study is a good one, if only it would make clear that the Commission has authority to seek information from all types of institutional investors, and to provide for a continuing flow of information.

I should say on a more mundane note that our staff is not so situated as to be able to conduct such a study, and a suggestion that there be a study I hope would be coupled with a very strong suggestion to, and an acceptance by, the Appropriations Committee of the need for additional resources.

In the meantime, I should point out that we are not waiting for that, that we have been exploring within the Government—and I have been having conversations with industry leaders outside the Government—ways and means of perhaps coordinating our several resources to this end, but the idea of a study, and the idea of directing the Commission to conduct one in my opinion would be a desirable one, provided we were able to carry it out and to continue the flow of information on a regular and continuing basis.

Mr. Moss. And you are now in the process of preparing an estimate of what your requirements are?

Mr. Cohen. I have already made those inquiries and, subject only to a more careful review of the figures, I can give you the tentative figures as I have them now.

We estimate that over a 2-year period we would need something between three-quarters of a million dollars and $1 million. Perhaps we could do it with a little less, particularly if we got a good deal of cooperation from outside organizations.

On a continuing basis we have estimated that it would cost between $200,000 and a quarter of a million dollars a year to have the staff to gather, to collate and to study, digest and produce the necessary information for the benefit not only of the Commission but of the entire industry and all the persons concerned.

I should say that this is not a matter of concern solely to the Commission. This is a matter of concern to anyone interested in our economy, and particularly in our capital markets. There is an interest in this in other departments and agencies of the Government, in the self-regulatory institutions and in the very institutional investors themselves. There are also other problems that go beyond mere market impact that would necessarily be involved in any such study.

Mr. Moss. Mr. Keith.

Mr. Keith. I would like to have you comment if you would by way of building the record to support the suggestion that you have just

made. On this institutional activity in the New York Stock Exchange report, they show the average number of blocks per month, blocks being 10,000 shares or more. You are certainly familiar with this document.

Mr. COHEN. I have seen it; yes, sir.

Mr. KEITH. They show, for example, that in 1965 there were a total of 181 block per month. In 1966 there were 304 blocks per month. In 1967, the first quarter, 462 block per month as an average. That is a 50-percent increase over the previous year in blocks per month and it is three times what it was in 1965. Do you have any comment to make?

Mr. COHEN. Yes.

Mr. KEITH. What has happened in successive quarters? Is that still accelerating?

Mr. COHEN. So far as I know that is still accelerating, and I should say that other activities are accelerating. I don't want to use this as a sounding board for my problems, but let me give you some indication of the situation with repect to new issues and trading volume. Since July 1, the beginning of our fiscal year, we have received I think almost twice as many registration statements as we did in the corresponding period last year, and the volume of trading on the exchanges has been at an average level of around 10 million shares a day, and there doesn't seem to be any sign that this is going to let up. My own feeling is that it will increase.

Now I would like to tie this together, and as you have invited me, to make a record. There is an aspect of the testimony given, particularly by the IBA, that I thought particularly interesting, and I hope you will indulge me a minute or two.

They talk about people's capitalism and about the necessity for liqiuidity of the markets and a few other things. They said liquidity meant having more shareholders, and there is an increasing number of shareholders all the time. Yet they insist on providing these great rewards to sellers who might otherwise invite their customers to buy listed securities, over-the-counter securities, thus increasing the liquidity, but because of these great rewards, these salesmen keep putting people into institutional investment media, and these institutions are growing at a great rate.

Now apart from the inconsistency of it, you can understand why I think these institutions will continue to grow, even if the Congress adopts every jot and tittle of our recommendations.

There is another argument they made in this field of sales charges which I think is terribly interesting and which is related to this point. They say that there are many small- and medium-sized firms that make local markets, that engage in distribution of small issues, that sell over-the-counter securities, and if you cut the sales charges for mutual funds, they will go out of business.

First, I don't believe it. If, however, it is true, consider what it means. It means that they are levying a heavy charge on the unsophisticated investor, by their own admission, in order to subsidize these other areas. Now maybe they are not making enough in the other areas, but that is no way to make up for it, by charging the unsophisticated investor with a high sales load. That is what they say. "If we don't get this high sales load, we are out of business." That is a very, very unusual position to take before this committee.

Mr. KEITH. This study goes on to point out that commercial banks are the largest net buyers. My question here is, and I got an answer yesterday and I just want to be reassured by you, that when a commercial bank buys, generally speaking, is it for the accounts for which they are trustee or is it occasionally the investment of a reserve or surplus?

Mr. COHEN. I would think generally speaking it is for the account of others, pension funds that they manage, for the account of commingled funds that they have created, common trust funds, or trusts in which they act as trustee, either solely or jointly.

In addition there may be some other activities of the banks in this area. Now this is one of the reasons why I answered your question by suggesting that a study would be helpful, because we would be able to improve our knowledge in this area. We would be able to improve our continuing understanding of the changing patterns that are going on in this field. Mr. Loomis would like to add a word.

Mr. LOOMIS. It is my understanding that the banking laws generally prevent commercial banks from dealing in ordinary corporate securities for their own account. They have to be acting here for others.

Mr. KEITH. One last question if I may, Mr. Chairman.

It points out where we talk about the number of block trades per month, the total volume from the New York Stock Exchange is reassuring in that it is only 5.5 percent.

My question is how broad a market do we really have when you think of the things that have triggered stock market recessions in years past. It may be to a large extent caused by a large movement in a narrow market.

Mr. COHEN. Well, there are a number of answers to that question, some of which I don't have. But let me try a few which may be personal reactions.

First of all, if we are speaking about mutual funds, and this is not necessarily true of pension funds, because of the redeemability feature, they want to be in a position to be as liquid as possible as quickly as possible, and it is required by law, except as there may be an emergency. This has generally limited the mutual funds to the largest companies with the largest number of shares outstanding.

Now if the company is large enough, for example, American Telephone & Telegraph, then perhaps the effect of an institution, or more than one institution, purchasing and selling the security may have a little effect on it. But if it is a smaller, albeit a large company, but a smaller one, and where the floating supply may be more limited, it seems to me quite reasonable to conclude that the activities of the funds may have a very, very important effect on the market action of that security, and we have sufficient information to support that as a matter of fact.

Indeed the speech which Chairman Moss introduced in the record refers to three cases, without identifying the companies, which perhaps illustrate the point that I have just made. Those three cases are just three of the cases which are part of our continuing study of this whole area, to which I referred in my letter to Chairman Moss in August, but you have made a point which I think is very significant.

These block sales have been increasing. As I indicated earlier, when I appeared here last, these are transactions effected off the exchange.

They are brought to the exchange and crossed on the tape. This is not the usual auction market with great depth and liquidity.

If the market itself could absorb them, they would go on the market instead of being arranged outside. But while the New York Stock Exchange has devised a number of procedures to deal with this problem, and I understand Mr. Haack said that at the moment it is fairly well under control, while Mr. Day, I understand perhaps suggested otherwise, I don't know, but I am convinced that this is a growing phenomenon.

The pension funds are still growing, and the mutual funds are growing, and they will continue to grow, and the insurance companies are getting into this activity in a very big way, and the banks propose to get into this activity in a very big way.

So it is inevitable that this problem will increase in size, and it would be very happy and very fortuitious and consistent with the traditions of this committee to initiate a study now before things are out of hand.

Mr. Moss. Thank you, Mr. Cohen, The bells have rung for the members to answer a quorum on the floor. So with regret I have to now discontinue these hearings. You will receive written questions, and your prompt attention to them will be appreciated.

Thank you for your appearance. Your statement, as submitted, will be included in the record of these hearings.

The committee will now stand adjourned.

Mr. COHEN. Thank you and the other members of the subcommittee.

(The following letter was received by the committee:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., November 7, 1967.

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

DEAR MR. KEITH: I am pleased to enclose the Commission's replies to the 12 questions which you submitted to us under cover of your letter of October 27.

If there is any further information you desire in connection with this legislation, please do not hesitate to call on me.

Sincerely,

MANUEL F. COHEN, *Chairman.*

Enclosures.

1. In the "over 50" stockholder suits referred to at p. 132 of the S.E.C. Report, "Public Policy Implications of Investment Company Growth":

a. How many fund shares were owned by each of the individual plaintiffs initiating the litigation?

Neither the individual complaints nor the reported court opinions in the stockholder suits attacking mutual fund advisory fees as excessive indicates, with one exception, how many fund shares were owned by the individual plaintiffs instituting the litigation. Therefore, we do not have this information with respect to each of the shareholder suits. The one exception is the litigation involving the management fees paid by Axe-Houghton Fund B. The court's opinion approving the settlement indicates that the plaintiff in that suit held 607 shares of the fund on March 21, 1962, the date suit was instituted. See *Kerner* v. *Crossman*, 211 F. 2d 397.

b. What was the value of each such plaintiff's shares on the day suit was brought?

The per share net asset value of one share of Axe-Houghton B was $9.16 on March 23, 1962. The 607 shares held by the plaintiff in the *Kerner* case were, therefore, valued at $5,559.12 on that date. Since we do not know how many fund shares were owned by the individual plaintiffs in the other suits, we cannot compute for each suit the value of their shares on the day suit was brought.

c. What would the maximum dollar recovery to each such individual plaintiff have been in each such suit?

Neither the complaints nor reported opinions in the individual cases indicated the maximum dollar amount of the recovery sought by the plaintiffs and we are unable to estimate the maximum potential recovery. In *Kerner* v. *Crossman*, the courts finally approved a settlement of the lawsuit which resulted in estimated savings to the fund of $291,462 per year based on the fund's size in 1962. We estimate that this resulted in savings of $8.73 per year for the 607 shares held by the plaintiff in that case.

In our view, the reasonableness of advisory fees cannot be justified in terms of the cost per shareholder. Our recommendations that mutual fund advisory fees be governed by a standard of reasonableness reflects our basic view that these managers of mutual funds, having created the funds and sold their shares with all the trappings and attractions of "mutual savings institutions", must be held to the same standards of fiduciary duty and self-restraint required of the managers of other types of "mutual savings institutions." Indeed, even in the ordinary corporate situation, the fairness of executive salaries or self-dealing contracts such as involved in advisory fees are not measured in terms of cost per shareholder. When the director of a manufacturing firm causes his company to deal with the supplier in which he has a financial interest and the supplier overcharges the manufacturing company, the business community does not attempt to justify the transaction on the ground that it costs only a few cents extra per shareholder. We know of no reason why self-dealing transactions such as involved in mutual fund advisory fees should be judged on a different basis.

2. Please list all the stockholder suits challenging mutual fund management fees which have been commenced in the past ten years and give the date each suit was initiated and its present status.

Attached hereto are tables listing separately all the shareholder suits challenging mutual fund management fees, which to our knowledge, have been commenced in the past 10 years. Table I lists the suits initiated prior to the publication of the Commission's Report. In many cases several complaints were filed attacking advisory fees of a single fund as excessive. Since Table I does not list the names of duplicate suits, the list consist of 22 cases rather than the 50 suits which actually were brought.

Table II lists the shareholder suits which have been brought after publication of the Commission's Report on December 2, 1966. Unlike the suits instituted prior to publication of the Commission's Report, the later suits are concerned mainly with questions of portfolio execution and brokerage allocation, rather than the advisory fees. However, since the reasonableness of advisory fees have been placed into issue by the allegations of the complaints, the names of these cases are furnished in answer to your inquiry.

TABLE I.—SHAREHOLDER SUITS INVOLVING MUTUAL FUND ADVISORY FEES INSTITUTED PRIOR TO PUBLICATION OF COMMISSION REPORT

Fund involved	Name of suit	Date brought	Disposition
1. Affiliated Fund, Inc	Kellmer v. Prankard	Aug. 26, 1960	Settled.
2. Axe-Houghton Fund A	Saxe v. Axe	April 1960	Do.
3. Axe-Houghton Fund B	Kerner v. Crossman	Mar. 21, 9061	Do.
4. Capital Shares, Inc	Nadel v. Curtin	March 1963	Do.
5. Chemical Fund, Inc	Miselman v. Eberstadt	1960	Do.
6. Diversified Growth Stock Fund	Greene v. Sheperd	February 1963	Do.
7. Dividend Shares, Inc	Brown v. Bullock	Aug. 5, 1960	Do.
8. Dreyfus Fund	Adler v. Dreyfus	Dec. 31, 1963	Do.
9. Fidelity Capital Fund, Inc	Levitt v. Johnson	August 1963	Do.
10. Fidelity Fund, Inc	Lefkof v. Johnson	July 10, 1961	Do.
11. Financial Industrial Fund, Inc	Acampora v. Birkland	February, 1961	Do.
12. Fundamental Investors, Inc	Saxe v. Brady	Jan. 29, 1960	Do.
13. Group Securities	Kirman, v. Anderson	April 1963	Do.
14. Investors Mutual, Inc	Ackert v. Ausman	July 28, 1960	Do.
15 .Investors Stock Fund, Inc	Glicken v. Bradford	Mar. 31, 1961	Do.
16 .Keystone Custodian Funds	Saminsky v. Abbott	August 1960	Do.
17. Lazard Fund, Inc. (The)	Saminsky v. Hettinger	Aug. 1, 1960	Do.
18. National Securities Series	Chabot v. Empire Trust Co	July 1960	Do.
19. One William Street Fund, Inc	Rosenfeld v. Richardson	July 1960	Do.
20. Television Electronics Fund, Inc	Simonson v. Cooley	Feb. 6, 1962	Do.
21. United Funds, Inc	Ruskay v. Reed	Aug. 1960	Do.
22. Wellington Fund, Inc	Rome v. Archer	July 12, 1960	Do.

TABLE II.—SHAREHOLDER SUITS INVOLVING MUTUAL FUND ADVISORY FEES INSTITUTED SINCE PUBLICATION OF COMMISSION REPORT

Fund involved	Name of suit	Date brought	Disposition
1. Manhattan Fund, Inc.	White et al. v. Auerbach et al.	Jan. 10, 1967	Pending.
2. Dreyfus Fund, Inc.	Schlusselberg v. Weissman et al.	do	Do.
3. Keystone Custodian Funds, Series S-3	Schlusselberg v. Investors Overseas Services, Ltd. et al.	do	Do.
4. American Investors Fund	Fogel, et al. v. Chestnutt, et al.	Jan. 6, 1967	Do.
5. United Funds, Inc.	Horenstein v. Waddell and Reed, Inc.	Oct. 26, 1967	Do.
6. Fidelity Capital Fund, Inc.	White v. Johnson	Jan. 10, 1967	Do.
7. Affiliated Fund	White v. Driscoll	Jan. 19, 1967	Do.

3. Why are the expenses of internally managed funds apparently lower than those of externally managed funds?

Internally managed funds are operated by their own officers and employees who, like most corporate executives, are compensated directly by their company through salaries and other readily disclosed forms of remuneration. For this reason, the management costs of the internally managed funds are subject to the restraints imposed by disclosure and conventional limitations on executive salaries that govern executive compensation in most areas of the economy.

These restraints are not present in the case of externally managed mutual funds, which usually pay for most management services by means of a fee based on a percent of the fund's assets, rather than by salaries and other common forms of executive remuneration. Appraisal by shareholders or directors of the fairness of these fees is far more complex than the appraisal of the reasonableness of the compensation paid to individual executives.

Even in the case of internally managed investment companies, the restraints of disclosure of and conventional limitations on executive salaries may have been weakened by the pattern of fees paid by externally managed companies. For example, the five trustee-directors of Massachusetts Investors Trust and Massachusetts Investors Growth Fund, Inc., received combined compensation in 1966 for their personal services to the funds in the amount of $2.2 million, an average of $450,000 per year for each of the five managers. Although this compensation is quite handsome by any standard, one of the two funds, MIT, has the lowest management expense ratio of any fund in the industry. As noted in the Commission's Report, a national magazine has reported that in 1951 when the funds managed by the MIT trustee-directors were much smaller and their compensation much less than today, the MIT trustees voluntarily imposed a limitation on their own salaries, because: "They decided that they were, or soon might be, making an embarrassingly good living from the trust."

In 1952 this limitation was dropped and the compensation of the MIT trustees has since increased in amounts that are closely proportionate to the growth of the funds under their management. The shareholders of Massachusetts Investors Trust, however, have been able to enjoy some of the economies available from the growth of their fund because management and other operating costs except those relating to trustee's compensation have not risen proportionately to the growth of the fund. MIT's management cost ratio in 1966 amounted to .12 percent of average net assets.

In contrast, the shareholders of externally-managed funds in many cases, have not received a fair share of the economies of size available from the growth of their funds. Over one-half of the externally-managed funds with assets of $100 million or more in 1966 paid advisory fees amounting to .48 percent or more of average net assets.

4. Section 22(d) of the Investment Company Act of 1940 precludes price competition between two salesmen selling the same fund. It does not preclude price competition between these salesmen and the salesmen of another fund which may have a lower load or no load. How can this existing competition be made more effective?

Given the present requirement for retail price maintenance in Section 22(d), we know of no way of significantly enhancing the effectiveness of price competition between funds.

As your question recognizes, most mutual fund transactions are initiated by salesmen. Accordingly, the only mutual fund prospectuses that the ordinary

investor ever gets to see are those that the salesman wants him to see. The ordinary small investor does not know of no load funds and consequently does not ask for such information. Indeed, he tends to rely on the recommendations of the salesman who he presumes is knowledgeable about the available alternatives. And it is quite natural for the salesman to want to sell that which is most remunerative for him.

If the salesman works for an integrated distributor that sells directly to the consumer through a so-called "captive sales force"—and a great many mutual fund salesmen work on this basis—he has only one group of funds to sell. All of the salesmen sell the shares of those funds at the same sales load. We know of no instance where a distributor which operates a "captive sales force" has attempted to obtain a competitive advantage by reducing its sales load to less than 8 percent. A distributor which reduced its sales load substantially might well be at a substantial disadvantage in competing for salesmen with those distributors which had a higher sales load and could therefore offer a higher rate of commission to the salesman. Indeed, in recent years, the largest captive sales organization *raised* its sales load from 7.5 to 8 percent.

In the case of funds distributed by independent broker-dealers, the customer again will generally see only those prospectuses that the salesman wants him to see. It is true that there are scores—indeed, hundreds—of funds that an independent broker-dealer *can* sell. But the ones that he actually *does* sell are likely to be the ones that he finds most remunerative. Unless his firm is sponsoring a no-load fund, which would be unusual, he is not likely to show a no-load fund prospectus. He would receive either no compensation for doing so or remuneration substantially less than the normal commission for selling load fund shares. Nor is he likely to direct his customer's attention to closed-end investment companies, which offer the very same type of diversification and the very same type of professional management that mutual funds do. When a salesman sells a closed-end security, he earns only a normal stock exchange commission. He earns a great deal more than that commission when he sells load fund shares. Hence the only investment companies that most broker-dealers and their salesmen are likely to discuss are load funds.

As noted below, in answer to Question 5, there are virtually no low load funds generaly available to the public. And since the general range of sales loads is between 7.5 and 8.5 percent, salesmen are unlikely to stress this small difference because of the likelihood of stimulating the customer to consider no-load funds or closed-end companies. The salesman feels no obligation to the customer, in choosing among comparable investment companies, to recommend the one which carries the lowest sales charge.

5. The committee has heard conflicting testimony whether a lower load will cause higher or lower sales of fund shares. What is the sales structure and experience of the seven funds which presently have sales charges ranging from 3 to 55%? How does the sales structure and experience of these funds compare with the sales structure and experience of funds charging an 8.5% load?

In our judgment, the sales experience of a low-load fund is of questionable relevance in determining whether a reduction in the generally prevailing level of sales loads will cause higher or lower sales of fund shares. Under present day conditions, large numbers of mutual funds available to dealers offer two or three times the dealer discount that a low-load fund can offer. It, therefore, cannot be expected that low-load funds would be aggressively sold. Moreover, as indicated in the mateials below, the low-load funds referred to in the question largely represent special situations. For this additional reason, their sales experience is not particularly helpful in attempting to answer the question presented.

Of the seven registered funds, listed below, whose reported sales charges in 1966 would come within the range of 3 to 5½%, the first has now raised its charge to 7½%, the second is available only to insurance companies, the third is available only to members of a teachers association, and the fourth is a high-grade bond fund which does not invest in equity securities. Thus, of the seven, there are only three funds in this sales load range which would be generally comparable to the standard load funds. Two of the remaining three funds are sold to the public directly by the distributor and have net assets of about $1 million and $7 million, respectively; the remaining fund has $62 million in assets and its shares are available through securities dealers, but only about 16 per cent of its shares are publicly held'

A. SUMMARY OF THE SALES STRUCTURE AND EXPERIENCE OF THE FUNDS INDICATED TO HAVE SALES CHARGES RANGING FROM 3 TO 5.5 PERCENT

Name of fund	Percent maximum sales charge	Fiscal yearend net assets
1. Equity Fund	[1] 7.5	$39,115,822
2. Insurors Mutual Fund	3.0	([2])
3. Teachers Association Mutual Fund of California	4.0	5,034,517
4. Keystone, B-1 Fund	4.15	9,341,858
5. Hampden Fund	4.0	1,128,249
6. Horace Mann Fund	4.0	6,786,248
7. Istel Fund	3.0	62,062,313

[1] On Nov. 30 1966 United Pacific Corp., the parent of Pacific Northwest Co. merged with Van Waters & Rogers, Inc. As a result, United Pacific Corp. the principal underwriter became the wholly owned subsidiary of VWR United Corp. The sales load on shares of this fund was raised from 3 percent in 1966 to the present rate of 7.5 percent.

[2] Shares are not distributed to the general public. Shares are made available solely for the common investment of surplus funds and reserves held by certain town mutual insurance companies located in the State of Wisconsin.

1. EQUITY FUND

Sales are now made through dealers under sales agreements allowing up to 6% dealers concession depending upon the amount invested. The fund is a diversified, open-end company whose objective is "to seek growth of capital and income." Shares are available to the general public.

SALES EXPERIENCE

	1966	1965	1964
Proceeds from sale of new shares	$5,713,104	$6,436,470	$5,655,971
Redemptions as a percent of new shares issued	29.6	23.2	22.1

2. INSURORS MUTUAL FUND

While this company is categorized as a mutual fund, it is not in the same category as the normal mutual fund. The shares of this company are available solely for the common investment of surplus funds and reserves held by certain town mutual insurance companies located in the State of Wisconsin. The town mutuals are insurance companies organized pursuant to Wisconsin law during the period from 1860–1927 in order to provide fire insurance coverage to persons within a limited rural vicinity. Thus, while IMF is a registered investment company, its shares are not available to the general public.

3. TEACHERS ASSOCIATION MUTUAL FUND OF CALIFORNIA

Sales of the fund shares are made directly by the principal underwriter. No sales are made through other brokers or dealers. The fund is an open-end, diversified investment company whose objectives are "long-term growth of capital and increasing income for the future." Shares of the fund are offered exclusively to members and employees of the California Teachers Association and their families rather than to the general public. The principal underwriter of the fund is the wholly-owned subsidiary of the California Teachers Association—Southern Section.

SALES EXPERIENCE

	1966	1965	1964
Proceeds from sale of new shares	$908,407	$678,904	$566,175
Redemptions as a percent of new shares issued	26.3	45.0	58.9

4. KEYSTONE CUSTODIAN FUND, SERIES B–1

Sales of shares of the fund are made through dealers who receive concessions ranging to 3%. This fund is one of nine separate funds in the Keystone group which encompasses combined assets of more than $1 billion. The Keystone Series B–1 Fund is an open-end, diversified company whose primary objective is "to secure the relative price stability of the High-Grade Bond Class with as liberal yield as can be obtained." Shares of this fund are made available to the general public.

SALES EXPERIENCE

	1966	1965	1964
Proceeds from sale of new shares	$24,849,454	$13,644,134	[1] $885,279
Redemptions as a percent of new shares issued	95.1	79.2	93.3

[1] 10-month period.

5. HAMPDEN FUND

Sales of fund shares are made directly by the distributor. There is no arrangement for dealers discount. The fund is an open-end, diversified company whose objective is "to provide long-term growth income and principal." Shares are available to the general public.

SALES EXPERIENCE

1966	1966	1965	1964
Proceeds from sale of new shares	$83,614	$88,681	$260,909
Redemptions as a percent of new shares issued	108.3	84.0	35.7

6. HORACE MANN FUND

Sales of shares are made directly upon application to the underwriter who retains the entire sales load. The fund is a diversified, open-end company whose objective is "capital growth and appreciation." Shares are available to the general public through salesmen employed by the principal underwriter.

SALES EXPERIENCE

	1966	1965	1964
Proceeds from sale of new shares	$1,106,245	$1,279,707	$875,724
Redemptions as a percent of new shares issued	38.3	31.9	49.4

7. ISTEL FUND (TOTAL NUMBER OF SHAREHOLDERS—820)

Shares are sold both directly by the principal underwriter and through dealers. On sales through dealers, the principal underwriter reallows the entire amount of sales load to the dealer. The fund is an open-end, diversified company whose objective is "to maintain a carefully selected and diversified investment portfolio which includes securities chosen for stability and their prospect of appreciation." Shares are available to the general public; however, most of fund's stock is owned by a small group in the following percentages:

	Percent
Officers and Directors	3.3
Curacao Securities Corp	61.1
Savings Corp., N.V	7.2
de Neuflize, Schlumberger, Mallet & Cie	12.2
Total	83.8

SALES EXPERIENCE

	1966	1965	1964
Proceeds from sale of new shares [1]	[2] $7,490,785	$3,432,052	$8,401,165
Redemptions as a percent of new shares issued	23.2	30.6	21.4

[1] The group indicated above has maintained approximately the same percentage of ownership throughout this period. Thus, it can be assumed that a substantial portion of the proceeds from the sale of new shares came from this group rather than from sales to the general public.

[2] On Dec. 7, 1966, the fund acquired the assets of Pallas Corp. in exchange for 1,157,653 shares of Istel. Not included in this figure is the $20,000,028 representing this acquisition.

B. MUTUAL FUND INDUSTRY IN GENERAL

The standard load funds are sold in one of two ways—either through dealer agreements which allow a dealer concession of a substantial portion of the sales charge or through the "captive" sales force. *Sales Experience* (Source: Investment Company Institute)

	1966	1965	1964
Total net assets	$34,829,400,000	$35,220,200,000	$29,116,300,000
Proceeds from sale of new shares	$6,422,100,000	$5,196,600,000	$4,016,200,000
Redemptions as percent of new shares issued	31.2	37.8	46.7

6. Would a relaxation of "tombstone ad" requirements for mutual funds help to reach prospective purchasers at less expense than is presently incurred? If mutual fund advertisements were only required to emphasize a few factors, such as management and sales expenses, would that result in more effective competition in the area emphasized?

The Securities Act of 1933 generally provides that advertisements for securities which are the subject of a registration statement filed with the Commission under that Act other than summary or full prospectuses, must be limited to identifying material with respect to the securities being offered. These restrictions apply to all securities subject to registration under the Securities Act and not only mutual fund shares. They reflect the Congressional determination that public offerings of securities should be made primarily through prospectuses containing adequate information material to informed investment decisions and not through advertisements.

In 1954 Congress again considered this question with particular reference to advertising of mutual funds and amended the Securities Act to give Commission rule-making power to permit some variation in the advertising restrictions of the Act for different types of securities. This amendment, however, was not intended to permit the Commission to adopt rules which go beyond the basic restriction of the Act against the sales of registered securities through advertisements which do not contain the basic information necessary to informed investment decisions. Nevertheless, the Commission, through adoption of Rule 134 in 1955 and subsequent interpretations has considerably liberalized restrictions on advertising. In recent years mutual funds have made greater use of advertising media in the sale of their shares.

The question of whether relaxation of tombstone advertisement requirements would enable mutual funds to reach investors more economically involves the question of whether such relaxation would result in a change in the existing competitive practice of the industry—substituting to some extent price competition for the favor of investors instead of the existing competition for the favor of dealers through sales compensation. Given the existing structure and sales methods of the industry, we doubt if a mere relaxation of requirements with respect to tombstone ads would bring about such a fundamental change in competitive practices. This is particularly true if one assumes that the restrictions on retail price competition imposed by Section 22(d) of the Investment Company Act would remain in effect.

At present there are certain funds which advertise quite extensively even within the existing limitations. Indeed, some funds use radio advertisements extensively while other funds have had their prospectuses printed as a supplement to

the Sunday edition of the *New York Times* and widely distributed. We have observed no correlation between the extent of advertising by various load funds and the sales load charged. Those which advertise widely in general have no lower sales loads than those which do not. This affords some support for the conclusions we have expressed.

The second part of the question is whether more emphasis in mutual fund advertisements on sales charges and management costs would result in more effective competition in the areas emphasized. We assume that this question does not refer to the prospectus where these matters are already required to be given considerable emphasis. The present tombstone rule permits the sales charge to be stated and no-load funds usually emphasize in their tombstone advertisements that there is no sales charge. Management expenses are presently not permitted to be included in such advertisements. This could be changed, but as we have pointed out in prior testimony and in the answers to other questions, meaningful disclosure with respect to management compensation for externally managed mutual funds presents complex and difficult problems and we doubt if this could effectively be done within the confines of a radio, television, or newspaper ad.

While the Commission has authority to modify the requirements concerning the tombstone ads, in exercising this authority we feel obligated to bear in mind the fact that in enacting the Securities Act of 1933 Congress did not intend tombstone advertisements to serve the function of sales literature as distinct from identifying securities proposed to be offered. We believe it was contemplated that the prospectus and literature supplementing the prospectus, rather than tombstone ads, would be utilized as sales literature.

7. What should the role of the S.E.C. be in any self-regulatory pattern of sales charge limitation?

The Commission should have adequate and effective oversight powers over the actions of self-regulatory organizations. The NASD, is responding to Senator Sparkman's suggestion that self-regulatory organizations might assume a responsibility over sales load, stated in its letter of June 16, 1967, that it would prefer to substitute Commission oversight of this kind provided in Section 15A (k) (2) of the Securities Exchange Act for the more extensive direct Commission rule-making power in this area now provided for in Section 22(c) of the Investment Company Act. The NASD's suggestion was as follows:

Section 22(c) of the 1940 Act now provides for SEC authority as to sales loads, which authority, if exercised, would supersede any previously exercised Association authority. We believe that duplicate authority should be eliminated in this area and that Commission oversight can be accomplished, as in the case as to other Association rules, by an appropriate amendment to Section 15A (k) (2) of the 1934 Act.

We believe the Section 15A(k) (2) oversight as suggested by the NASD would be adequate for the protection of investors.

The Commission has had similar oversight powers since 1934 over stock exchange commission rates pursuant to Section 19(b) of the Securities Exchange Act. In his testimony before the Senate Committee, Mr. Keith Funston, then president of the New York Stock Exchange, suggested that a 19(b) type procedure might be utilized in connection with NASD supervision of maximum sales loads and suggested that this procedure "seems to be working in our area."

The subject of self-regulation and the nature and function of Commission oversight was considered in some detail in Chapter IV of the Report of the Special Study of Securities Markets, particularly pages 693 through 728. The essential conclusions are stated on page 723 as follows:

Although governmental oversight of self-regulation is essential, the workability of self-regulation depends also on restraint in the Commission's exercise of its reserve power. The relationship between the Commission and the self-regulatory organizations has at times been referred to as a "partnership" or "cooperative regulation." Under either expression the roles of the Commission and the self-regulatory agencies are essentially complementary, and the self-regulatory agencies must enjoy such autonomy as will enable them to act as responsible, dynamic partners in a cooperative enterprise.

It is in this spirit that we would endeavor to work with the NASD in the area of determining maximum sales loads for mutual funds. It has been our consistent policy in matters of this type not simply to substitute our judgment for that of the self-regulatory bodies but to attempt to resolve any differences of view in a mutually satisfactory result. In the administration of Section 19(b), dealing with stock exchange commission rates, the Commission has only once in past 33 years

found it necessary to hold a formal proceeding and to require the Exchange to modify one of its requirements.

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?

It might be observed at the outset that the Commission has not basically objected to the front-end load on the grounds stated in the "specific objections." Our chief objection is that at the time on investor purchases a front-end load plan certificate, he cannot know what his financial future will be nor whether through the next ten years he will be willing to invest in the same mutual fund.

Changes in financial condition result—

(i) not only from death, but also from the birth of additional children;

(ii) not only from unemployment, but also from the failure of an employed or self-employed person's income to keep pace with increases in the cost of living;

(iii) not only from illness, but also from an unexpectant need for a healthy investor to support aging relatives who are healthy yet unable to provide for themselves;

(iv) not only because of hardship expenses, but also because of unforeseeable expenses in providing for the well-being of his family; and

(v) not only because he has unavoidable expenses, but because he believes it would be morally undesirable to avoid them.

Similarly, when the investor begins his contractual plan he cannot know whether the fund's performance in future years will be such that he will wish to continue to purchase its shares, or that his investment objectives will remain the same as the fund's. Other mutual fund investors can and do decide to invest new money in different mutual funds. The ICI Shareholder Survey indicates that over half of mutual fund lump sum purchases own shares of two or more mutual funds. But the front-end load penalizes the contractual plan investor to a uniquely heavy extent if he decides to make his future investments in another fund. The disclosures and the 30- or 60-day refund privilege, which for many years have been offered him at the time of his purchase, have no bearing on these future contingencies.

It might also be observed that the front-end load does not merely penalize those who redeem at a loss in the early years of the plan. It penalizes all who fail to complete their payments, including the many who lapse but do not redeem their certificates.

Our answers to the specific questions asked follow:

(a) *What percentage of planholders have been forced to liquidate for hardship reasons?*

We have two sources of information. One is the survey conducted for the Special Study by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania. Part of that survey was concerned with those who redeemed contractual plans. Eighty-six percent stated that they redeemed their certificate to use the profits for a specific purpose. The specific purposes stated by such persons were as follows: payment of medical or hospital bills (9%); payment of other types of debt (34%); purchase of durable consumer goods such as automobiles, furniture, etc. (9%); vacation (2%); education expenses (7%); other household or personal expenditures (19%); purchase of home (9%); investment in a business (5%); purchase of shares in another mutual fund (5%); purchase of common stock other than fund shares (3%); purchase of other types of securities (8%); open or increase savings accounts (7%); and, some other purpose (3%).[1]

The above responses indicate that those who redeemed did so for a great variety of reasons. Among those who did so to pay debts, medical or hospital bills accounted for 9%, but payment of other types of debt accounted for a far larger percentage.

The other known source of information is a survey conducted on behalf of the Association of Mutual Fund Plan Sponsors which was referred to in the testi-

[1] Report of Special Study of Securities Markets, House Doc. No. 95, Pt. 4, 88th Cong., 1st Sess., p. 372. The figures add up to more than 100% because some respondents offered more than one specific reason.

mony before the Subcommittee of Mr. John H. Kostmayer. The questionnaire consisted of two questions, as follows:

1. When you liquidated a mutual fund investment plan in 1966, did you do so because you *chose* to put this money to some other use, or because circumstances *required* you to raise cash?

[ ] Chose to [ ] Circumstances required

2. Did you have any other financial resources which you could have used instead of liquidating your investment plan?

[ ] Yes, had other resources [ ] No, did NOT have other resources

Among the respondents, 55% said that circumstances required them to redeem. Of these, 45% said they had no other resources. The fact that the remaining 10% had other resources does not mean, as the plan sponsors' suggest, that as a practical matter these investors did not have to redeem. When required by circumstances to raise cash, a person who has only a small amount of emergency funds may properly feel that he cannot liquidate them in order to maintain his contractual plan investment which is subject to the risks of the market. Similarly, many of the 44% who stated that they "chose" to redeem may have inferred from the wording of the question that they had had a real choice in determining whether to liquidate their emergency funds or to redeem their certificate. We doubt that even the plan sponsors believe that that is a realistic choice. Yet their questionnaire did not take this factor into consideration.

Thus it appears that a large majority of those who redeem uncompleted contractual plans at a loss are forced to do so by reason of changed financial circumstances.

(b) *How many of these have liquidated at a loss?*

Other statistics of the plan sponsors indicate that 17% (or about one out of six) of their investors redeem uncompleted contractual plans at a loss. This is an average. Investors in some contractual plans fare better than others because of differences in their fund's performance. As pointed out in the Commission's Report, 33% of the investors in one contractual plan redeemed at a loss as did 25% of the investors in another contractual plan. Most of those investors would have a profit if the normal sales load rather than the front-end load were deducted from their payments.

It is highly significant that the questionnaire was put to those who redeemed a plan starting anywhere from several months to over *five* years after their initial purchase. Yet the Plan Sponsors Association has offered a hardship refund limited to a period of only *one* year after the purchase of a contractual plan.

(c) *What is the aggregate loss sustained by such persons in a typical twelve-month period?*

The Commission does not have the necessary data to answer this question.

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?

The prospectuses of most contractual plans already indicate on their front page that the investor may invest in the underlying mutual fund shares on a lump sum or a level-load plan basis at normal rather than front-end load sales charges. However, given the great disparity which exists between the immediate compensation a salesman can earn from selling a contractual rather than a voluntary plan, it would be difficult to assume that his oral sales presentation would refer to the level-load voluntary plan, or, if it did, that such oral presentations would result in a fair comparison of the relative merits of contractual and voluntary plans in the same fund. Given the six times greater sales compensation from the first year's payments for the sale of a contractual plan, there is much doubt as to whether prospective purchasers can be made effectively aware of the existence of level-load plans and of their relative merits. This is not to suggest that disclosures in the prospectus could not be improved. However, we do not believe that improved prospectus disclosure will be adequate to meet the problem.

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?

We do not have data showing the median loss. However, statistics of the plan sponsors showing the 10- and 12-year experience of investors in four contractual plans indicates that the *average* loss was about $67 per account among those which were redeemed up to 10 or 12 years after being opened and before completion of 36 payments.

Nor do we know what would have been the median experience of this group of investors in four plans if they had instead invested in voluntary plans. However, an indication of the impact of the front-end load on investor profits and losses is available for one of these four contractual plans. It is presented in Chart E on page 96 of the October 10, 1967 Statement of the Securities and Exchange Commission before the Subcommittee on Securities of the House Committee on Interstate and Foreign Commerce on H.R. 9510 and 9511.

Chart E compares profits or losses at the end of each year between 1955 and 1964 on investments made in a particular balanced fund through both the contractual and voluntary plan. Assuming investments of $100 per month, at the end of the first year, the voluntary plan would have been worth $8 less than the $1,200 paid in, but the contractual plan would have been worth $565 less than the $1,200 paid in. At the end of the fourth year of systematic monthly payments, the profit on the voluntary plan would have been $748, but the profit on the contractual plan would have been $169. (The differences likely would have been greater had the experience of a growth fund rather than a balanced fund been considered.)

In the typical situation, at the end of the first twelve payments, a contractual plan investor has about 47% less invested than does a voluntary plan investor. His profits will be proportionately less than those of the voluntary plan investor. If he redeems at a loss, it too will be substantially greater for the contractual plan investor than for the voluntary plan investor. And the contractual plan investor who has as many as 24 payments will have about 23% less invested than under a voluntary plan. After having made 36 payments, at which point his effective sales load is about 19%, he will have about 14% less invested than under a voluntary plan. During the three years there will have been, on the average, more than a 14% difference between the amount invested under the contractual as opposed to the voluntary plan.

11. What changes in the proposed legislation may be necessary to accommodate and encourage no-load funds?

In our judgment, no changes in the proposed legislation are necessary to accommodate and encourage no-load funds. Aside from proposals with respect to sales charges which do not apply to the no-load funds, we do not believe that the legislative proposals affect no-load funds in a manner differently from load funds or would be burdensome to the no-load funds.

Mr. Ronald T. Lyman, Jr., spokesman for the no-load funds, testified before the Subcommittee to the effect that the legislation would place a particular burden upon the disinterested director of a no-load fund in those instances where, as permitted by law, a no-load fund has only one such director.

We do not believe that this is necessarily the case. The legislation would require the investment adviser to supply to all of the directors information with respect to the reasonableness of the investment advisory compensation and it would be the duty of all of the directors to consider and evaluate this information. This responsibility is not imposed solely on the disinterested director. We think that such a requirement of consideration and evaluation is implicit in the requirement of existing law that all the directors, including the disinterested director or directors, must approve the investment advisory contract. At the hearings industry witnesses and others differed in their views as to the seriousness with which the directors have in the past viewed this responsibility, but we believe all agreed that such a responsibility does exist and the furnishing of information would assist the directors in discharging that responsibiilty as well as directing their attention to the matter.

It also seemed to be generally agreed at the hearings that investment advisory fees should be reasonable. While the evaluation of the fee in the case of a no-load fund may involve somewhat different factors than are present in the case of a load fund, we would see no basis for exempting no-load funds from any requirement that fees be reasonable.

12. What has the experience of NYSE Monthly Investment Plan investors [1] been in the following areas:

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[1] As of March 31, 1967, there were 217,263 MIP accounts in force through New York Stock Exchange member firms. Of these, 187,000 are handled through Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch). About one half are individual regular MIP accounts and the rest are payroll deduction plans. The latter are not pertinent to the present discussion since the individual purchaser (employee) does not pay any commission; the employer pays a lump sum commission. The above discussion pertains only to the handling of individual MIP accounts. The Commission has not made an independent study of MIP. All of the information has been provided either by Merrill Lynch or the New York Stock Exchange.

a. How many have liquidated at a loss?

To our knowledge neither the Exchange, the odd-lot firms, nor the Commission houses have any data which could show how many MIP's have been liquidated at a loss. In fact, on termination not all accounts are liquidated—some customers ask for possession of their certificates so there is no way of telling when or at what price they eventually sell them.

b. What is the lapse ratio on M.I.P.?

Inasmuch as the Monthly Investment Plan is for no stated fixed term, it is not wholly appropriate to speak of them as "lapsing." In this framework, we are advised that the life span of the average MIP is about 3 years. Merrill Lynch's experience has been that over this three year period an average of about one year's payments are made, but the average payment is about twice the amount of the minimum installment called for by the plans. Thus the average MIP investor pays in an amount equivalent to the minimum periodic installments for the first two years of his plan. At the time of termination only about ⅓ of the investors ask that their MIP accounts be liquidated—the rest either ask to have their certificates sent to them, leave the account dormant or go into another security. This is one of the reasons why it is difficult to determine if a customer has sustained a loss at the termination of the plan.

c. What is the average percentage sales charge paid by M.I.P. Investors?

The Exchange and Merrill Lynch estimate that the "sales charge" paid by the average MIP investor is approximately 8%, considering his cost in and out and taking into account the odd-lot differential. The maximum commission charge is 6% of money invested for transactions of $100 or less. Since the average payment is a little over $100, the commission is slightly under 6%. At termination the average account has a value of $1500 and the commission upon liquidation is $20 or 1.3 percent. The remainder consists of the odd-lot differential.

d. What sales material and other disclosures does the purchaser receive?

The investor receives a booklet called "Investing on a Budget" which includes an order blank, together with any financial or research reports he asks for.

e. How is the suitability of the investment for the investor determined?

The suitability of the security selected by the customer is determined for the most part on the basis of the same factors used in determining suitability for other customers. The Exchange's rule on "Know your customer" is equally relevant for MIP accounts. Overall, the MIP is intended to appeal to the long range investor who has only limited funds available for investment and seeks the advantages of dollar-cost-averaging.

An indication of the type of securities chosen is reflected by the 10 most popular securities in MIP accounts as of mid-May, 1967:

1. American Tel & Tel
2. General Motors
3. Radio Corp of America
4. General Tel & Electronics Corp.
5. Int'l Business Machines Corp.
6. Sears, Roebuck
7. General Electric Co.
8. Eastman Kodak Co.
9. Tri-Continental Corp., (a closed-end investment company)
10. Standard Oil of New Jersey

More than 50% of the total MIP accounts are in these securities.

f. What advice and service does the purchaser receive?

The primary advantage provided by the Monthly Investment Plan is the opportunity to purchase fractional shares of stocks on a budget, and the option of having his dividends automatically reinvested.

The MIP customer is given the same general advice and service that is given to regular customers of the broker/dealer. For instance, the member firm holds his securities without charging a custodial fee. In addition, MIP customers of Merrill Lynch receive at least three times a year a publication called *Market Highlights* which gives a concise summary of general economic trends together with a succinct report concerning the customer's security among others. This service is available only to MIP customers of Merrill Lynch.

(The following letter and material was received by the committee:)

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., November 6, 1967.

Hon. JOHN E. MOSS,
Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, House of Representatives, Washington, D.C.

DEAR MR. MOSS: Enclosed are the responses to your requests of October 26, 1967. They include:

1. A table showing net assets, total expenses and advisory fees, and fee rates and expense ratios for all active mutual funds which had reported a full year's operations on June 30, 1967;

2. A table showing the basic management fee rate, and each level at which that rate is reduced, for mutual funds registered with the Commission;

3. The Commission's June 30, 1967 index of active registered investment advisers, principal underwriters, sponsors and underlying companies (may be found in committee's files);

4. A table showing the income, expenses and profits of 13 publicly held advisory organizations;

5. A table showing the sales loads, and breakpoints for quantity purchases, of mutual fund shares;

6. Two tables showing sales and redemptions of mutual fund shares by size of fund for the sixteen months ended September 30, 1967.

With respect to item 3, I would like to point out that additional data for earlier years may be found in tables III–8 and III–9, at pages 122 and 124 of our Report. These tables are limited to organizations which are required to publish reports under the 1934 Act because they are publicly held. Attempts by the Commission to obtain such data on a regular basis from other advisory organizations have been opposed by the industry.

The tables referred to in item 6 show that of 158 funds reporting data, 110 were in a net sales status for the 16 months ended September 30, 1967. Of the 48 that were in a net redemption status, 12 were not offering shares, and 28 of the remaining 36 had average net assets of under $100 million during this period. The 36 funds offering shares that were in a net redemption status accounted for a total of $165 million in net outflow, with about 27 percent of that figure coming from one large fund. The 110 funds in a net sales status had about $4 billion in net sales, with over $3 billion coming from the 65 funds in which sales were more than double redemptions.

I hope we have been responsive to your requests.

Sincerely,

MANUEL F. COHEN, *Chairman.*

Enclosure.

ITEM 1

Name of fund	Net assets as of June 30, 1967 (thousands)	Total expenses (thousands)	Advisory fee (thousands)	Expense ratios (percent)	Advisory fee rate (percent)
1. Investors Mutual, Inc	$2,660,836.5	$9,743.9	$9,743.9	0.34	0.34
2. United Funds, Inc	2,433,744.6	9,047.7	8,529.4	.39	.38
3. Massachusetts Investors Trust	1,967,048.8	3,933.6	2,749.0	.19	.14
4. Wellington Fund, Inc	1,849,140.1	7,286.7	4,838.2	.38	.26
5. Investors Stock Fund, Inc	1,692,047.6	6,337.1	6,337.1	.36	.36
6. Dreyfus Fund Inc	1,634,845.5	8,870.0	7,497.7	.59	.50
7. Affiliated Fund, Inc	1,227,065.2	4,160.1	3,027.8	.33	.24
8. Fundamental Investors, Inc	1,086,646.2	5,752.2	4,717.9	.51	.42
9. Insurance Securities Trust Fund, as sponsored by Insurance Securities, Inc	1,083,099.6	6,345.5	6,345.5	.58	.58
10. Fidelity Trend Fund, Inc	983,109.6	4,780.6	3,814.1	.54	.43
11. Massachusetts Investors Growth Stock Fund, Inc	890,853.5	3,137.1	1,778.1	.35	.20
12. National Securities Series	757,636.3	4,492.2	3,213.4	.78	.56
13. Fidelity Fund, Inc	605,037.0	3,079.3	2,444.8	.50	.40
14. Investors Variable Payment Fund, Inc	576,215.2	1,673.5	1,673.5	.34	.34
15. Investment Co. of America	561,591.4	2,809.6	1,846.5	.52	.34
16. National Investors Corp	554,563.7	1,035.9	528.0	.19	.10
17. Television-Electronics Fund, Inc	545,671.0	2,990.1	2,097.5	.62	.43
18. Hamilton Funds, Inc	489,971.7	3,180.1	2,521.3	.66	.50
19. Puritan Fund, Inc	478,315.8	2,232.1	1,753.6	.49	.38
20. Fidelity Capital Fund, Inc	425,176.9	2,276.5	1,786.0	.59	.46
21. Chemical Fund, Inc	411,280.6	1,626.4	1,268.6	.38	.30

ITEM 1—Continued

Name of fund	Net assets as of June 30, 1967 (thousands)	Total expenses (thousands)	Advisory fee (thousands)	Expense ratios (percent)	Advisory fee rate (percent)
22. Putnam, George Fund of Boston	$383,771.2	$1,732.9	$1,391.6	0.44	0.35
23. Keystone Custodian Fund, series S–4	355,469.6	1,648.4	1,648.4	.56	.56
24. Broad Street Investing Corp	353,187.8	663.2	324.2	.20	.11
25. Boston Fund, Inc	340,938.0	1,985.8	1,688.4	.54	.46
26. Dividend Shares, Inc	338,587.8	1,712.8	1,115.7	.45	.29
27. State Street Investment Corp	330,666.7	1,689.4	1,489.2	.50	.44
28. Putnam Growth Fund	323,597.9	1,972.8	1,544.2	.54	.42
29. American Mutual Fund, Inc	318,592.5	1,987.9	1,447.3	.61	.44
30. Delaware Fund, Inc	302,279.7	1,979.1	1,472.2	.67	.50
31. Financial Industrial Fund, Inc	292.125.5	2,257.1	2,207.9	.67	.66
32. Group Securities, Inc	275,001.6	2,161.6	1,483.7	.71	.49
33. Putnam Investors Fund, Inc	248,120.8	1,349.3	1,040.4	.53	.41
34. Eaton & Howard Stock Fund	231,407.6	1,364.0	1,158.5	.57	.50
35. 1 William Street Fund, Inc	228,882.2	1,153.3	767.4	.50	.33
36. Axe-Houghton Fund B, Inc	228,303.1	1,741.4	1,433.5	.68	.56
37. Selected American Shares, Inc	214,472.7	1,117.3	923.3	.61	.50
38. Washington Mutual Investors Fund, Inc	211,228.3	1,076.9	765.2	.68	.48
39. Diversified Growth Stock Fund, Inc	202,697.0	1,263.4	891.7	.68	.50
40. Channing Shares, Inc	200,401.9	1,302.2	964.3	.68	.50
41. Eaton & Howard Balanced Fund	198,836.8	1,191.9	1,018.1	.57	.50
42. Keystone Custodian Fund, series K–2	190,506.0	1,158.5	1,158.5	.57	.57
43. Commonwealth Investment Co	185,951.6	1,047.5	859.5	.59	.48
44. Colonial Fund, Inc	181,426.6	1,034.5	850.5	.50	.41
45. Putnam Income Fund, Inc	162,008.0	768.6	500.1	.45	.29
46. Diversified Investment Fund, Inc	147,554.9	1,013.8	768.4	.64	.50
47. Penn Square Mutual Fund	146,137.9	807.5	700.9	.58	.50
48. Massachusetts Life Fund	143,296.1	771.5	699.6	.55	.50
49. Federal Street Fund, Inc	139,828.0	772.7	714.2	.53	.50
50. Keystone Custodian Fund, series B–4	139,530.7	484.6	312.3	.56	.22
51. Keystone Custodian Fund, series S–3	138,720.1	850.6	850.6	.57	.57
52. Stein Roe & Farnham Balanced Fund, Inc	135,440.7	607.9	543.2	.55	.49
53. Institutional Investors Mutual Fund, Inc	131,075.8	203.5	184.3	.20	.18
54. Keystone Custodian Fund, series K–1	130,065.4	726.7	726.7	.57	.57
55. Scudder, Stevens & Clark Common Stock Fund, Inc	127,864.2	738.9	595.4	.62	.50
56. Loomis-Sayles Mutual Fund, Inc	125,595.7	760.4	610.6	.59	.47
57. Keystone Custodian Fund, series S–2	118,553.5	786.7	786.7	.57	.57
58. Scudder, Stevens & Clark Balanced Fund, Inc	112,291.3	707.6	583.1	.61	.50
59. Dow Theory Investment Fund, Inc	108,576.2	741.1	515.7	.72	.50
60. Bullock Fund, Ltd	108,269.0	466.2	283.6	.39	.25
61. Life Insurance Investors, Inc	103,947.2	563.0	285.9	.58	.30
62. Century Shares Trust	102,879.0	443.7	270.5	.42	.25
63. Mutual Investing Foundation	102,840.4	635.7	410.3	.71	.45
64. Investment Trust of Boston	95,432.1	519.8	280.3	.58	.31
65. Diversification Fund, Inc	92,488.0	495.1	442.6	.56	.50
66. Depositors Fund of Boston, Inc	90,159.5	464.8	409.7	.57	.50
67. Windsor Fund, Inc	89,118.5	684.1	438.4	.73	.50
68. American Investors Fund, Inc	84,884.6	739.0	529.7	1.09	.77
69. Pioneer Fund, Inc	84,802.1	634.9	493.6	.74	.58
70. Value Line Income Fund, Inc	83,579.6	631.9	456.4	.71	.51
71. Capital Shares, Inc	83,015.9	926.3	648.7	1.02	.75
72. Oppenheimer Fund, Inc	82,231.9	1,114.6	703.3	1.58	1.00
73. Texas Fund, Inc	81,201.0	587.4	475.8	.62	.50
74. Shareholders' Trust of Boston	76,754.4	550.9	421.2	.66	.50
75. Nation-Wide Securities Co., Inc	73,413.2	367.8	198.7	.43	.25
76. Stein Roe & Farnham Stock Fund, Inc	72,369.9	335.5	293.1	.57	.50
77. Philadelphia Fund, Inc	71,008.1	481.8	349.3	.69	.50
78. Exchange Fund of Boston, Inc	68,699.5	196.0	170.0	.57	.50
79. Commonwealth Income Fund, Inc	67,405.6	411.7	351.9	.59	.50
80. Westminster Fund, Inc	64,707.0	393.0	336.7	.57	.50
81. Johnston Mutual Fund, Inc	64,634.6	406.7	296.0	.68	.50
82. Istel Fund, Inc	62,062.3	330.9	213.9	.76	.50
83. York Fund, Inc	58,143.3	1,619.9	895.0	4.10	2.26
84. Lexington Reserach Investing Corp	57,109.0	473.6	329.8	.84	.60
85. Colonial Growth Shares, Inc	56,963.0	358.2	245.4	.73	.50
86. Industries Trend Fund, Inc	56,727.9	290.1	211.2	.51	.50
87. Scudder Special Fund, Inc	54,328.4	273.3	209.2	.66	.50
88. Associated Fund Trust	51,256.1	470.4	382.1	.75	.60
89. Keystone Custodian Fund, series S–1	50,378.9	290.0	290.0	.57	.57
90. Axe-Houghton Fund A, Inc	49,400.4	506.1	350.8	.92	.64
91. Income Fund of Boston, Inc	48,753.4	412.6	242.7	.71	.50
92. Supervised Investors Growth Fund, Inc	48,661.1	42.6	5.2	1.02	.12
93. Steadman Science & Growth Fund, Inc	48,523.0	405.3	232.1	.88	.50
94. Savings Bank Investment Fund	47,041.6	34.6	19.1	.08	.05
95. Canada General Fund, Inc	45,623.7	395.3	205.7	.72	.38
96. Channing Income Fund, Inc	44,338.9	335.6	236.2	.71	.50
97. Fund of America, Inc	44,211.0	185.7	100.0	.93	.0
98. Pine Street Fund, Inc	42,979.7	171.4	118.5	.40	.27
99. Blue Ridge Mutual Fund, Inc	42,878.6	327.5	203.1	.75	.49

ITEM 1—Continued

Name of fund	Net assets as of June 30, 1967 (thousands)	Total expenses (thousands)	Advisory fee (thousands)	Expense ratios (percent)	Advisory fee rate (percent)
100. Energy Fund, Inc	$42,752.8	$377.1	$232.3	0.81	0.50
101. Congress Street Fund, Inc	42,521.1	255.0	225.5	.57	.50
102. Franklin Custodian Funds, Inc	41,587.7	351.6	221.2	.75	.50
103. Aberdeen Fund	41,136.4	338.0	209.6	.81	.50
104. Investors Selective Fund, Inc	40,138.1	209.6	164.7	.48	.38
105. First Investors Stock Fund, Inc	40,063.9	264.1	219.8	.60	.50
106. Equity Fund, Inc	39,115.8	482.6	442.3	1.21	.11
107. Growth Industry Shares, Inc	37,120.0	202.2	168.8	.48	.40
108. Income Foundation Fund, Inc	36,441.8	316.7	182.9	.86	.50
109. Enterprise Fund, Inc	36,425.1	423.8	142.9	.90	.30
110. Invest Fund, Inc	35,503.9	232.3	164.0	.98	.46
111. Guardian Mutual Fund, Inc	31,671.2	254.0	172.7	.74	.50
112. Value Line Special Situations Fund, Inc	31,515.3	305.4	224.9	1.02	.75
113. Convertible Securities Fund, Inc	31,371.1	215.7	126.9	.84	.50
114. Commonwealth Fund Indenture of Trust, plans A and B	31,201.4	215.8	215.7	.57	.57
115. Commonwealth Stock Fund, Inc	31,145.6	225.4	165.3	.68	.50
116. Provident Fund for Income, Inc	31,128.6	182.9	90.7	.90	.50
117. Channing Securities, Inc	31,057.2	282.8	180.8	.79	.50
118. Decatur Income Fund, Inc	30,829.9	239.0	164.2	.73	.50
119. Scduder International Investments Ltd	30,675.2	243.5	163.5	.75	.50
120. Wisconsin Fund, Inc	29,746.9	171.1	122.2	2.30	1.64
121. Axe Science Corp	29,266.5	258.2	117.2	.85	.40
122. Commonwealth Fund Indenture of Trust, plans C and D	29,132.8	227.7	200.8	.74	.65
123. Devonshire Street Fund, Inc	29,054.8	168.2	133.2	.63	.50
124. De Vegh Mutual Fund, Inc	28,621.0	118.1	72.4	.50	.31
125. Republic Technology Fund, Inc	27,176.3	311.5	82.2	1.02	.23
126. Canadian Fund, Inc	27,128.8	216.6	111.6	.73	.38
127. Price, Rowe New Horizons Fund, Inc	26,629.0	191.4	140.9	.94	.69
128. Bank Fiduciary Fund	26,192.1	39.5	23.8	.17	.10
129. Imperial Capital Fund, Inc	26,030.6	221.8	189.4	.82	.50
130. Composite Fund, Inc	25,380.9	203.3	171.2	.74	.63
131. Northeast Investors Trust	25,163.5	174.3	123.3	.68	.50
132. New England Fund	25,070.2	181.3	120.5	.75	.50
133. Price, T. Rowe Growth Stock Fund, Inc	24,705.2	1,278.2	900.0	.58	.41
134. Boston Personal Property Trust	24,585.0	55.8	23.9	.22	.10
135. American Business Shares, Inc	24,368.9	189.3	97.3	.73	.38
136. Chase Fund of Boston	24,267.8	209.4	137.2	.70	.45
137. Investors Capital Exchange Fund, Inc	23,055.6	153.4	132.5	.58	.50
138. Mutual Investment Fund of Connecticut, Inc	22,911.9	46.7	42.4	.20	.18
139. Axe-Houghton Stock Fund, Inc	22,419.9	240.5	127.8	1.12	.50
140. Financial Industrial Income Fund, Inc	22,303.3	110.7	73.4	.49	.50
141. Morton, B. C. Fund, Inc	21,405.2	212.7	156.7	.99	.75
142. Twentieth Century Investors, Inc	18,344.7	153.1	77.6	.99	.50
143. Bondstock Corp	17,842.1	98.7	82.8	.71	.60
144. General Investors Trust	17,735.3	131.6	45.0	.73	.50
145. Peoples Securities Corp	17,725.7	149.7	96.8	.78	.50
146. Value Line Fund, Inc	17,539.7	130.8	94.5	.77	.57
147. Wall Street Investing Corp	16,366.1	133.5	80.3	.82	.50
148. Fairfield Fund, Inc	15,581.0	81.8	16.6	1.10	.11
149. Whitehall Fund, Inc	15,402.1	57.8	16.0	.36	.10
150. Winfield Growth Fund, Inc	14,980.0	120.7	68.6	.88	.50
151. Loomis-Sayles Canadian & International Fund, Ltd.	14,736.0	134.0	98.5	.85	.63
152. Finance Co. of Pennsylvania	14,714.7	111.0	10.4	.72	.07
153. Crown Western Investments, Inc	14,099.7	129.4	72.9	.77	.50
154. Knickerbocker Fund	12,569.1	145.7	140.5	1.04	1.00
155. Dodge & Cox Balanced Fund	12,520.5	81.0	63.0	.64	.50
156. Stein Roe & Farnham International fund, Inc	12,393.5	91.9	60.1	.67	.44
157. Commonwealth Capital Fund, Inc	12,014.4	59.6	38.9	.77	.50
158. Employers' Group Fund, Inc	11,508.9	88.3	46.7	.75	.40
159. Life Insurance Stock Fund, Inc	11,354.0	93.8	57.1	.77	.50
160. Composite Bond & Stock Fund, Inc	11,186.1	98.2	76.8	.81	.63
161. Insurance Investors Fund, Inc	11,075.4	96.1	50.6	.94	.49
162. American Growth Fund, Inc	10,912.2	99.1	97.8	.99	.98
163. Keystone Custodian Fund, series B-2	10,886.2	64.5	41.6	.57	.38
164. Commingled Investment account of First National City Bank	10,833.9	37.7	26.9	.71	.50
165. Associations Investment Fund, Inc	10,616.0	80.3	79.3	.95	.95
166. Mutual Trust	10,422.4	100.7	100.7	.90	.90
167. Foursquare Fund, Inc	10,074.1	82.3	50.1	.80	.50
168. Fiduciary Mutual Investing Co., Inc	9,986.9	81.7	55.3	.74	.50
169. Loomis-Sayles Capital Development Fund, Inc	9,957.6	68.2	37.6	.91	.50
170. Security Equity Fund, Inc	9,932.8	52.1	26.7	.92	.50
171. Essex Fund, Inc	9,876.7	79.9	51.5	.79	.50
172. United Funds Canada-International Ltd	9,765.6	118.5	61.7	.96	.50
173. Security Investment Fund, Inc	9,700.3	101.0	51.5	.82	.50
174. Transatlantic Fund, Inc	9,436.6	94.4	55.0	.90	.38

ITEM 1—Continued

Name of fund	Net assets as of June 30, 1967 (thousands)	Total expenses (thousands)	Advisory fee (thousands)	Expense ratios (percent)	Advisory fee rate (percent)
175. Keystone Custodian Fund, series B-1	$9,341.9	$35.8	$23.1	0.29	0.25
176. Federated Funds, Inc	9,296.9	100.7	51.0	.98	.50
177. Consultant's Mutual Investments, Inc	9,089.2	79.5	46.4	.50	.50
178. Varied Industry Plan, Inc	8,847.3	84.1	2.5	1.09	.03
179. Nassau Fund	8,657.2	66.7	42.3	.79	.50
180. Selected Insurance and Financial Equities Trust Fund	8,448.6	36.9	36.9	.50	.50
181. Midamerica Mutual Fund, Inc	8,406.9	45.8	36.8	.63	.50
182. Common Stock Fund of State Bond & Mortgage Co	8,299.6	60.7	35.2	.87	.50
183. NEA Mutual Fund, Inc	7,841.6	37.9	5.6	.67	.50
184. Supervised Shares, Inc	7,656.2	61.9	35.9	.84	.49
185. Securities Fund, Inc	7,269.1	75.9	37.4	1.06	.53
186. Lexington Income Trust	6,798.0	76.8	34.1	1.05	.50
187. Mann, Horace Fund, Inc	6,786.2	71.0	9.3	.91	.12
188. Naess & Thomas Special Fund, Inc	6,690.6	55.6	39.6	.82	.50
189. Farm Bureau Mutual Fund, Inc	6,556.5	37.6	17.8	.77	.50
190. Florida Growth Fund, Inc	6,483.3	69.6	36.6	.95	.50
191. Knickerbocker Growth Fund, Inc	6,154.7	62.4	11.2	1.05	.18
192. Keystone International Fund, Inc	5,895.8	55.7	35.1	.75	.69
193. Gryphon Fund, Inc	5,756.9	30.5	21.6	.71	.50
194. Sterling Investment Fund, Inc	5,737.1	37.8	27.3	.69	.50
195. Security Diversified Shares, Inc	5,586.7	24.0	20.7	.58	.50
196. Beacon Investing Corp	5,323.0	40.6	5.8	.80	.11
197. Nassau Physicians Guild Investing Co., Inc	5,235.6	25.9	5.3	.52	.10
198. Drexel Equity Fund, Inc	5,099.7	47.7	19.8	1.10	.50
199. Paramount Mutual Fund, Inc	5,082.6	52.4	52.4	1.00	1.00
200. Teachers Association Mutual Fund of California, Inc	5,057.9	49.9	26.5	.92	.50
201. Sovereign Investors, Inc	4,941.1	49.5	26.6	.09	.50
202. Imperial Growth Fund, Inc	4,800.9	42.2	28.0	1.01	.50
203. Templeton Growth Fund, Ltd	4,748.7	46.4	23.5	1.02	.50
204. Unified Mutual Shares, Inc	4,736.3	42.3	8.8	.81	.17
205. Magellan Fund, Inc	4,668.0	34.8	19.3	.90	.50
206. Western Industrial Shares, Inc	4,493.5	32.6	14.6	1.01	.45
207. Mutual Shares Corp	4,442.5	59.7	31.7	1.18	.63
208. Revere Fund, Inc	4,197.1	98.5	38.8	2.00	.78
209. New World Fund, Inc	4,116.2	36.5	18.1	1.00	.50
210. Country Capital Investment Fund, Inc	4,113.9	31.9	15.5	1.06	.50
211. Investors Research Fund, Inc	4,089.0	46.8	10.5	1.02	.23
212. Memphis & Shelby County Medical Society, Inc., investment-retirement trust	3,846.1	48.5	8.1	1.37	.50
213. Steadman's Shares in American Industry, Inc	3,684.2	33.0	15.8	1.03	.50
214. Insurance & Bank Stock Fund, Inc	3,652.4	34.5	20.1	.80	.50
215. Steadman Investment Fund, Inc	3,591.8	36.8	18.0	1.02	.50
216. M.S.B. Fund, Inc	3,266.8	29.0	10.6	1.13	.38
217. National Industries Fund, Inc	3,202.0	31.7	11.0	1.00	.50
218. Preston Moss Fund, Inc	3,125.0	37.4	25.4	1.03	.75
219. Consumers Investment Fund, Inc	2,952.4	23.2	15.1	.75	.50
220. Concord Fund, Inc	2,810.9	31.4	3.3	.96	.11
221. Nelson Fund, Inc	2,732.6	65.0	10.8	1.36	.38
222. Allen, Leon B., Fund, Inc	2,677.2	27.2	15.2	1.14	.64
223. Independence Fund, Inc	2,587.2	12.9	4.0	.76	.50
224. Industry Fund of America, Inc	2,579.5	14.8	10.5	.72	.50
225. Old Dominion Investors' Trust, Inc	2,514.2	28.0	21.3	1.00	.75
226. Citadel Fund, Inc	2,478.1	54.2	9.3	1.67	.50
227. Advisers Fund, Inc	2,426.2	20.1	12.8	.77	.50
228. Mairs & Power Growth Fund, Inc	2,423.6	16.2	11.5	.71	.50
229. Capital Income Fund, Inc	2,302.6	37.7	17.6	.68	.75
230. Brown Fund of Hawaii, Ltd	2,272.6	18.8	11.5	.82	.50
231. Newton Fund, Inc	2,215.0	15.2	10.9	.70	.50
232. Liberty Fund, Inc	2,159.0	25.4	8.9	1.43	.50
233. Prudential Fund of Boston, Inc	2,108.2	15.0	10.4	.71	.50
234. Mercer Fund, Inc	2,091.1	22.7	8.9	.80	.50
235. American Diversified Investors Fund, Inc	1,783.0	14.7	7.0	1.05	.50
236. First National Fund, Inc	1,768.5	7.9	4.0	1.07	.50
237. General Securities, Inc	1,768.3	24.7	10.5	1.18	.50
238. Viking Growth Fund, Inc	1,737.2	11.3	8.0	1.20	.75
239. Variable Stock Fund, Inc	1,732.6	12.3	8.5	.72	.50
240. Vanderbilt Mutual Fund, Inc	1,683.2	9.9	7.5	.65	.50
241. Bernstein-Macaulay Special Fund, Inc	1,663.3	23.7	10.7	1.29	.57
242. First Participating Fund, Inc	1,636.9	20.3	.6	1.01	.50
243. Hartwell & Campbell Fund, Inc	1,617.9	20.2	12.1	.40	.75
244. Dodge & Cox Stock Fund	1,570.2	10.3	2.0	.69	.50
245. Southwestern Investors, Inc	1,567.1	111.7	85.6	.66	.50
246. Blair Fund, Inc	1,540.7	40.5	22.3	1.30	.75
247. Foundation Life Stock Fund, Inc	1,457.0	17.5	7.4	1.24	.50
248. Coastal Security Investment Fund	1,416.7	11.5	6.3	.78	.50
249. American Investment Counseling Fund, Inc	1,262.7	11.5	11.5	1.00	1.00

ITEM 1—Continued

Name of fund	Net assets as of June 30, 1967 (thousands)	Total expenses (thousands)	Advisory fee (thousands)	Expense ratios (percent)	Advisory fee rate (percent)
250. Counselors Investment Fund, Inc	$1,198.0	$12.2	$6.5	0.94	0.50
251. Over-the-Counter Securities Fund, Inc	1,144.0	12.9	5.0	1.30	.50
252. International Investors, Inc	1,138.3	12.5	6.0	1.02	.50
253. Insurors Mutual Fund, Inc	1,120.6	6.2	5.4	.55	.50
254. Hampden Fund, Inc	1,110.3	13.6	5.3	1.30	.50
255. United Fund, accumulative series TA	1,108.0	9.2	9.2	.86	.39
256. National Western Fund, Inc	1,102.9	43.7	8.9	3.69	.75
257. Pilot Fund, Inc	1,092.0	9.6	2.3	.58	.50
258. American Pacific Fund, Inc	1,030.2	9.8	9.6	1.00	1.00
259. Pioneer Enterprise Fund, Inc	1,020.6	13.5	2.5	1.17	.22
260. Capital Investors Growth Fund, Inc	981.9	8.9	6.6	1.02	.75
261. Colonial Equities, Inc	952.0	4.9	4.9	.50	.5
262. Pilgrim Fund, Inc	886.7	9.5	5.8	.50	.31
263. Vanguard Fund, Inc	837.3	9.3	4.5	1.03	.50
264. Financial Fund, Inc	835.2	5.7	4.4	.65	.50
265. Diversified Fund of State Bond & Mortgage Co	833.4	8.7	4.3	1.00	.50
266. Mairs & Power Income Fund, Inc	788.9	5.8	3.7	.79	.50
267. First Mutual Fund of Rhode Island, Inc	770.5	31.4	5.5	4.72	.81
268. All American Fund, Inc	765.9	3.1	2.6	.91	.75
269. Rittenhouse Fund	755.3	52.2	3.9	.64	.50
270. Meridian Fund, Inc	752.0	5.6	.8	.75	.11
271. Mathers Fund, Inc	715.5	7.1	1.5	.65	.50
272. American Enterprise Fund, Inc	693.2	16.0	6.2	1.65	.64
273. Ivy Fund, Inc	677.7	10.5	3.6	1.40	.48
274. Trans American Fund, Inc	671.1	6.6	6.5	1.04	1.00
275. Bridges Investment Fund, Inc	651.3	6.4	3.2	1.00	.50
276. Plico Fund, Inc	612.7	3.7	5.4	1.04	.50
277. Worth Fund, Inc	610.1	53.0	5.4	4.75	.75
278. Samson Fund, Inc	601.5	37.2	9.3	6.89	1.55
279. Mutual Income Fund, Inc	588.6	6.6	3.3	1.00	.50
280. Wade Fund, Inc	569.0	10.1	5.1	1.78	.90
281. Planned Investment Fund, Inc	537.3	11.7	2.4	2.47	.50
282. Venture Securities Fund, Inc	433.4	17.5	4.6	3.80	1.00
283. Israel-American Diversified Fund, Inc	416.2	17.1	2.0	3.89	.50
284. Puerto Rican Investors Fund, Inc	367.4	10.0	2.8	2.14	.60
285. Growth Fund of America, Inc	351.9	1.8	1.8	.50	.5
286. Connecticut Western Mutual Fund, Inc	321.1	4.5	1.8	1.30	.50
287. Unifund, Inc	310.5	5.5	1.0	1.04	.21
288. Market Growth Fund, Inc	306.6	5.1	1.9	1.90	.75
289. Invested Dollars Fund, Inc	290.9	8.5	1.3	3.31	.50
290. Transwestern Mutual Fund	273.0	1.6	1.6	.62	.60
291. Josten Growth Fund, Inc	220.6	1.8	.8	.99	.50
292. American Insurance Investors Stock Fund, Inc	218.5	1.3	.7	.77	.50
293. America and Israel Growth Fund, Inc	216.7	15.4	1.9	3.89	.75
294. Foundation Stock Fund, Inc	211.4	6.8	1.6	2.00	.50
295. Murray Hill Fund, Inc	207.5	22.6	1.5	11.30	.75
296. Pennsylvania Mutual Fund, Inc	191.1	2.7	1.0	1.39	.51
297. Scythian Fund, Inc	136.1	3.3	.1	3.05	.50
298. Everyman Fund, Inc	124.4	1.5	.1	1.24	.50
299. First Security Growth Fund, Inc	113.3	1.2	.6	.96	.50
300. Park Fund, Inc	112.3	5.3	6.8	4.02	.50

ITEM 2
[Dollars in millions]

Name of fund	1st step		2d step		3d step		4th step		5th step		Final step		Net assets, June 30, 1966	Advisory fee ratio (percent)	Expense ratio (percent)
	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets over—			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
Midwest Investment Co	0.200	$1	0.125	$2	------	------	------	------	------	------	0.100	$2	(1)	(1)	------
Bernstein-Macaulay Special Fund, Inc	.750	2	------	------	------	------	------	------	------	------	.500	------	$2	0.57	1.29
First Mutual Fund of Rhode Island, Inc	1.000	2	.875	3	0.750	$4	------	------	------	------	.500	5	1	.81	4.72
Mutual Shares Corp	1.000	2	------	------	------	------	------	------	------	------	.500	2	4	.63	1.18
Beacon Investing Corp	.200	3	------	------	------	------	------	------	------	------	.100	3	5	.11	.80
Nassau Physicians Guild Investing Co., Inc	.200	3	------	------	------	------	------	------	------	------	.100	3	5	.10	.52
Venture Securities Fund, Inc	1.000	3	------	------	------	------	------	------	------	------	.750	3	0	1.00	3.80
Value Line Fund, Inc	.750	4	------	------	------	------	------	------	------	------	.500	4	18	.57	.77
Value Line Income Fund, Inc	.750	4	------	------	------	------	------	------	------	------	.500	4	84	.51	.71
America and Israel Growth Fund, Inc	.750	5	.500	15	------	------	------	------	------	------	.250	15	0	.75	3.89
Blair Fund, Inc	.750	5	.500	100	------	------	------	------	------	------	.500	------	2	.75	1.30
First Investors Stock Fund, Inc	1.000	5	.500	25	.500	50	------	------	------	------	.500	50	40	.50	.60
Over-the-Counter Securities Fund, Inc	.500	5	------	------	------	------	------	------	------	------	.450	5	1	.50	1.30
Price, Rowe New Horizons Fund, Inc	1.000	5	.750	10	------	------	------	------	------	------	.500	10	27	.69	.94
Mann, Horace, Fund, Inc	.125	6	------	------	------	------	------	------	------	------	.100	6	7	.12	.91
Connecticut Western Mutual Fund, Inc	.500	10	------	------	------	------	------	------	------	------	.250	------	0	.50	1.30
Greenfield, Samual Fund, Inc	1.000	10	.750	20	------	------	------	------	------	------	.500	------	(1)	------	------
Growth Industry Shares, Inc	.500	10	------	------	------	------	------	------	------	------	.375	10	37	.40	.48
Preston Moss Fund, Inc	.750	10	------	------	------	------	------	------	------	------	.500	------	3	.75	1.03
Worth Fund, Inc	.750	10	.500	60	.330	110	------	------	------	------	.250	------	1	.75	4.75
Associations Investment Fund, Inc	.950	15	------	------	------	------	------	------	------	------	.750	15	11	.95	.95
Knickerbocker Fund	.250	15	.200	25	------	------	------	------	------	------	.125	25	13	1.00	1.04
Institutional Investors Mutual Fund, Inc	.300	20	.200	40	------	------	------	------	------	------	.100	40	131	.18	.20
M. S. B. Fund, Inc	.375	20	.250	40	------	------	------	------	------	------	.125	40	3	.38	1.13
Nassau Fund	.500	20	.375	60	------	------	------	------	------	------	.250	60	9	.50	.79
Bondstock Corp	1.000	25	------	------	------	------	------	------	------	------	.500	25	18	.60	.71
Convertible Securities Fund, Inc	.500	25	.450	125	.400	225	0.350	$325	0.300	$425	.250	425	31	.50	.84
Paramount Mutual Fund, Inc	1.000	25	.750	50	------	------	------	------	------	------	.500	50	5	1.00	1.00
Pilgrim Fund, Inc	.750	25	.625	100	.500	500	------	------	------	------	.400	500	1	.31	.50
Unifund, Inc	.990	25	.850	50	------	------	------	------	------	------	.510	50	0	.21	1.04
Blue Ridge Mutual Fund, Inc	.500	30	.400	150	------	------	------	------	------	------	.350	150	43	.49	.75
De Vegh Mutual Fund, Inc	.500	35	.375	07	------	------	------	------	------	------	.250	------	29	.31	.50
Pine Street Fund, Inc	.500	35	.375	07	------	------	------	------	------	------	.250	7	43	.27	.40
Affiliated Fund, Inc	.500	50	.375	100	.250	600	------	------	------	------	.200	------	1,227	.24	.33

[1] No assets.

ITEM 2—Continued

[Dollars in millions]

Name of fund	1st step		2d step		3d step		4th step		5th step		Final step		Net assets, June 30, 1966	Advisory fee ratio (percent)	Expense ratio (percent)
	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets over—			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
American Investors Fund, Inc.	0.800	$50	0.600	$100	0.400	$200	0.300	$300	0.250	$400	0.200	500	$85	0.77	1.09
Concord Fund, Inc.	.750	50	.625	100	------	------	------	------	------	------	.500	------	3	.11	.96
Financial Industrial Fund, Inc.	.750	50	------	------	------	------	------	------	------	------	.450	1,500	292	.66	.67
Gryphon Fund, Inc.	.500	50	.440	100	.380	150	.310	200	------	------	.250	200	6	.50	.71
Guardian Mutual Fund, Inc.	.500	50	.375	100	------	------	------	------	------	------	.250	------	32	.50	.74
Murray Hill Fund, Inc.	.750	50	.500	100	.333	150	------	------	------	------	.250	150	0	.75	1.30
Mutual Investing Foundation	.500	50	.400	100	.300	150	.200	200	------	------	.100	200	103	.45	.71
New England Fund	.500	50	.460	100	------	------	------	------	------	------	.400	100	25	.50	.75
Pioneer Fund, Inc.	.600	50	.500	100	------	------	------	------	------	------	.500	100	85	.58	.74
Price, T. Rowe, Growth Stock Fund, Inc.	.500	50	.400	150	------	------	------	------	------	------	.350	150	25	.41	.58
Putnam Investors Fund, Inc.	.500	50	.400	300	------	------	------	------	------	------	.350	300	248	.41	.53
Wisconsin Fund, Inc.	.500	50	.400	100	------	------	------	------	------	------	.300	100	30	1.64	2.30
Chemical Fund, Inc.	.500	75	.280	125	------	------	------	------	------	------	.200	500	411	.30	.38
Eberstadt Fund, Inc.	.500	75	.375	125	.250	500	------	------	------	------	.200	------	(1)	------	------
Income Fund of Boston, Inc.	.500	75	------	------	------	------	------	------	------	------	.100	------	49	.50	.71
Meridian Fund, Inc.	.500	75	.375	125	.250	175	------	------	------	------	.125	175	1	.11	.75
Americana Fund, Inc.	.150	100	.100	------	------	------	------	------	------	------	------	------	(1)	------	------
Axe-Houghton Fund A, Inc.	.500	100	.400	300	.300	500	------	------	------	------	.250	------	49	.64	.92
Axe-Houghton Fund B, Inc.	.500	100	.400	300	.300	500	------	------	------	------	.250	------	228	.56	.68
Colonial Equities, Inc.	.500	100	------	------	------	------	------	------	------	------	.375	------	1	.50	.50
Colonial Fund, Inc.	.500	100	------	------	------	------	------	------	------	------	.375	------	181	.41	.50
Colonial Growth Shares, Inc.	.500	100	------	------	------	------	------	------	------	------	.375	------	57	.50	.73
Dividend Shares, Inc.	.500	100	.250	300	------	------	------	------	------	------	.200	------	339	.29	.45
Exeter Fund, Inc.	.500	100	.375	200	------	------	------	------	------	------	.250	200	(1)	------	------
Exeter Second Fund, Inc.	.500	100	.375	200	------	------	------	------	------	------	.250	200	(1)	------	------
Exeter Third Fund, Inc.	1.000	100	------	------	------	------	------	------	------	------	.250	200	(1)	------	------
First Investors Income Fund, Inc.	.500	100	------	------	------	------	------	------	------	------	.800	------	(1)	------	------
Foursquare Fund, Inc.	.500	100	------	------	------	------	------	------	------	------	.375	------	10	.50	.80
Franklin Custodian Funds, Inc.	.500	100	------	------	------	------	------	------	------	------	.375	------	42	.50	.75
Lazard Fund, Inc.	.500	100	.375	150	------	------	------	------	------	------	.375	------	(1)	------	------
Loomis-Sayles Mutual Fund, Inc.	.500	100	------	------	------	------	------	------	------	------	.250	150	126	.47	.59
Moody's Capital Fund, Inc.	.500	100	.375	150	------	------	------	------	------	------	.375	100	(1)	------	------
Putnam, George, Fund of Boston	.500	100	.350	200	------	------	------	------	------	------	.250	150	384	.35	.44
Shareholders' Trust of Boston	.500	100	.400	300	.300	500	------	------	------	------	.300	200	77	.50	.66
Stein Roe & Farnham Balanced Fund, Inc.	.500	100	------	------	------	------	------	------	------	------	.250	------	135	.49	.55
											.400	100			

Unified Mutual Shares, Inc	.280	100									.250		5	.17	.81
Wellington Fund, Inc	.500	100	.375	200	.250	1,400					.225	1,400	1,849	.26	.38
Windsor Fund, Inc	.500	100	.375	200							.250	200	89	.50	.73
Capital Income Fund, Inc	.750	125	.625	200							.500	200	2	.75	.68
Capital Investors Growth Fund, Inc	.750	125	.625	200							.500	200	1	.75	1.02
Capital Shares, Inc	.750	125	.625	200							.500		83	.75	1.02
Scudder, Stevens & Clark Balanced Fund, Inc	.500	125									.400	125	112	.50	.61
Scudder, Stevens & Clark Common Stock Fund, Inc	.500	125									.400	125	128	.50	.62
Washington Mutual Investors Fund, Inc	.500	125									.450	125	211	.48	.68
American Mutual Fund, Inc	.500	150	.400	300	.360	600					.333	600	319	.44	.61
Commonwealth Investment Co	.500	150									.400	150	186	.48	.59
Keystone Custodian Fund, series B-2	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	11	.38	.57
Keystone Custodian Fund, series B-3	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	(1)		
Keystone Custodian Fund, series B-4	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	140	.22	.56
Keystone Custodian Fund, series K-1	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	130	.57	.57
Keystone Custodian Fund, series K-2	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	191	.57	.57
Keystone Custodian Fund, series S-1	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	50	.57	.57
Keystone Custodian Fund, series S-2	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	119	.57	.57
Keystone Custodian Fund, series S-3	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	139	.57	.57
Keystone Custodian Fund, series S-4	.750	150	.625	500	.525	750	.485	1,000	.450	1,250	.415	1,250	355	.56	.56
One William Street Fund, Inc	.375	1 0									.250	150	229	.33	.50
Putnam Growth Fund	.500	150	.400	300							.350	300	324	.42	.54
Dow Theory Investment Fund, Inc	.500	200									.350		109	.50	.72
Fidelity Capital Fund, Inc	.500	200	4.500	300							.400		425	.46	.59
Fidelity Fund, Inc	.500	200									3.500		605	.40	.50
Fidelity Trend Fund, Inc	.500	200	.450	300							.400		983	.43	.54
Penn Square Mutual Fund	.490	200									.400	200	146	.50	.59
Puritan Fund, Inc	.400	200	.375	400							.350		478	.38	.48
State Street Investment Corp	.500	200	.375	300							.300	300	331	.44	.50
Balanced Income Fund, Inc	.500	215	.375	550	.300	800					.250	800	2	.00	.72
Supervised Investors Growth Fund, Inc	.500	215	.375	550	.300	800					.250	800	49	.12	1.02
Television-Electronics Fund, Inc	.500	215	.375	550	.300	800					.250	800	546	.43	.62
Boston Fund, Inc	.500	250	.375	350							.250	350	341	.46	.54
California Mutual Fund	.500	250	.400	500	.375	1,000					.250	1,000	(1)		
Equity Fund, Inc	.500	250	.375	500							.250	500	39	1.11	1.21
Group Securities, Inc	.500	250	.475	375	.450	500	.425	750			.400		275	.49	.71
Index Fund of Boston, Inc	.500	250	.475	500	.450	750	.425	1,000	.400	1,250	.375	1,500	(1)		
Manhattan Fund, Inc	.500	250	.475	500	.450	750	.425	1,000	.400	1,250	.375	1,500	(1)		
Midgate Corp	.500	250									.400	250	0	0	.78
Presidential Investment Fund, Inc	.500	250	.450	350							.400	350	(1)		
Steadman Investment Fund, Inc	.500	250									.450	250	4	.50	1.02
Steadman Science & Growth Fund, Inc	.500	250									.450	250	49	.50	.88
Financial Dynamics Fund, Inc	.500	250									.350	1,500	(1)		
First Investors Fund for Growth, Inc	.530	300	.470	600	.440	900	.410	1,200	.380	1,500	.500		(1)		
Investment Company of America	.750	300	.625	500							.324	300	562	.34	.52
Investors Mutual, Inc	.360	300									.350	1,400	2,661	.34	.34
Investors Stock Fund, Inc	.500	350	.470	650	.440	900	.410	1,150	.350	1,408	.350	1,400	1,692	.36	.36
	.500	350	.470	650	.440	900	.410	1,150	.380	1,400					

[1] No assets.

ITEM 2—Continued

[Dollars in millions]

Name of fund	1st step		2d step		3d step		4th step		5th step		Final step		Net assets, June 30, 1966	Advisory fee ratio (percent)	Expense ratio (percent)
	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets over—			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
Investors Variable Payment Fund, Inc	0.500	$350	0.470	$650	0.440	$900	0.410	$1,150	0.380	$1,400	0.350	$1,400	$576	0.34	0.34
National Securities Series	.500	410	------	------	------	------	------	------	------	------	.375	410	758	.56	.78
Employers' Group Fund, Inc	.500	500	------	------	------	------	------	------	------	------	.375	------	12	.40	.57
Fundamental Investors, Inc	.500	500	.400	750	.350	1,000	.300	1,250	.250	1,500	.200	------	1,087	.42	.15
Hamilton Funds, Inc	.500	500	.400	750	.300	1,000	------	------	------	------	.250	1,000	490	.50	.66
Massachusetts Investors Growth Stock Fund, Inc	.250	500	.150	750	.100	1,000	------	------	------	------	.050	1,000	891	.20	.35
United Funds, Inc	.500	500	.450	1,000	.400	1,500	.375	2,000	------	------	.350	2,000	2,434	.38	.39
Amcap Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	------	------
Aberdeen Fund	Perf.	------	------	------	------	------	------	------	------	------	------	------	41	.50	.81
Acme Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	0	0	2.48
Advisers Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	2	.50	.77
Algonquin Fund, Inc	.750	------	------	------	------	------	------	------	------	------	------	------	(1)	------	------
All American Fund, Inc	Perf.	------	------	------	------	------	------	------	------	------	------	------	1	.75	.91
Allen Leon B. Fund, Inc	.375	------	------	------	------	------	------	------	------	------	------	------	3	.64	1.14
American Business Shares, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	24	.38	.73
American Diversified Investors Fund, Inc	1.000	------	1.000	------	------	------	------	------	------	------	------	------	2	.50	1.05
American Enterprise Fund, Inc	1.000	------	------	------	------	------	------	------	------	------	------	------	1	.64	1.65
American Growth Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	11	.98	.99
American Insurance Investors Stock Fund, Inc	1.000	------	------	------	------	------	------	------	------	------	------	------	0	.50	.77
American Investment Counseling Fund, Inc	1.000	------	------	------	------	------	------	------	------	------	------	------	1	1.00	1.00
American Pacific Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	1	1.00	1.00
American Variable Annuity Fund	.600	------	------	------	------	------	------	------	------	------	------	------	(1)	------	------
Associated Fund Trust	.500	------	------	------	------	------	------	------	------	------	------	------	51	.60	.75
Axe-Houghton Stock Fund, Inc	.400	------	------	------	------	------	------	------	------	------	------	------	22	.50	1.12
Axe Science Corp	.100	------	------	------	------	------	------	------	------	------	------	------	29	.40	.85
Bank Fiduciary Fund	1.000	------	------	------	------	------	------	------	------	------	------	------	26	.10	.17
Bank Stock Fund, Ltd	.800	------	------	------	------	------	------	------	------	------	------	------	(1)	------	------
Beacon Hill Mutual Fund, Inc	.100	------	------	------	------	------	------	------	------	------	------	------	01	0	.10
Boston Personal Property Trust	.500	------	------	------	------	------	------	------	------	------	------	------	25	.10	.22
Bridges Investment Fund, Inc	.110	------	------	------	------	------	------	------	------	------	------	------	01	.50	1.00
Broad Street Investing Corp	.500	------	------	------	------	------	------	------	------	------	------	------	353	.11	.20
Brown Fund of Hawaii, Ltd	.250	------	------	------	------	------	------	------	------	------	------	------	02	.50	.82
Bullock Fund, Ltd	.375	------	------	------	------	------	------	------	------	------	------	------	108	.25	.39
Canada General Fund, Inc	.375	------	------	------	------	------	------	------	------	------	------	------	46	.38	.72
Canadian Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	27	.38	.73
Capital Exchange Fund, Inc													(1)		

Cemetery Care Investment Fund, Inc	.500												(1)	
Centennial Fund, Inc	.500												(1)	
Central Mutual Fund, Inc	.500												0	0 .99
Century Shares Trust	.250												103	.25 .42
Chandler Fund, Inc	.500												(1)	
Channing Income Fund, Inc	.500												44	.50 .71
Channing Securities, Inc	.500												31	.50 .79
Channing Shares, Inc	.500												200	.50 .68
Chase Fund of Boston	.500												24	.45 .70
Citadel Fund, Inc	.450												2	.50 1.67
Coastal Security Investment Fund	.500												1	.50 .78
Columbia Balanced Fund, Inc	.500												(1)	
Columbia Growth Fund, Inc	.750												(1)	
Commingled Investment Account of First National City Bank	.750												11	.50 .71
Common Stock Fund of State Bond & Mortgage Co	.500												8	.50 .87
Commonwealth Capital Fund, Inc	.500												12	.50 .77
Commonwealth Income Fund, Inc	.500												67	.50 .59
Commonwealth Stock Fund, Inc	.500												31	.50 .68
Composite Bond & Stock Fund, Inc	.625												11	.63 .81
Composite Fund, Inc	.625												25	.63 .74
Congress Street Fund, Inc	.500												43	.50 .57
Constitution Exchange Fund, Inc	.500												(1)	
Consultant's Mutual Investments, Inc	.500													.50 .50
Consumers Investment Fund, Inc	.500												3	.50 .75
Contrafund, Inc	.500												(1)	
Counselors Investment Fund, Inc	.500												1	.50 .94
Country Capital Investment Fund, Inc	.500												4	.50 1.06
Crown Western Investments, Inc	.500												14	.50 .77
Decatur Income Fund, Inc	.500												31	.50 .73
Delaware Fund, Inc	.500												302	.50 .67
Depositors Fund of Boston, Inc	.500												90	.50 .57
Devonshire Street Fund, Inc	.500												29	.50 .63
Diversification Fund, Inc	.500												92	.50 .56
Diversified Fund of State Bond and Mortgage Co	.500												1	.50 1.00
Diversified Growth Stock Fund, Inc	.500												203	.50 .68
Diversified Investment Fund, Inc	.500												148	.50 .64
Dodge & Cox Balanced Fund	.500												13	.50 .64
Dodge & Cox Stock Fund	.500												2	.50 .69
Drexel Equity Fund, Inc	.500												5	.50 1.10
Dreyfus Fund Inc	.500												1,635	.50 .59
Eaton & Howard Balanced Fund	.500												199	.50 .57
Eaton & Howard Stock Fund	.500												231	.50 .57
Empire Fund, Inc	.500												(1)	
Energy Fund, Inc	.500												43	.50 .81
Enterprise Fund, Inc	Perf.												36	.30 .90
Essex Fund, Inc	.500												10	.50 .79
Everest Income Fund, Inc	.500													

[1] No assets.

ITEM 2—Continued

[Dollars in millions]

Name of fund	1st step		2d step		3d step		4th step		5th step		Final step		Net assets, June 30, 1966	Advisory fee ratio (percent)	Expense ratio (percent)
	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets over—			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
Everyman Fund, Inc.	0.500	------	------	------	------	------	------	------	------	------	------	------	0	0.50	1.24
Exchange Fund of Boston, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	$69	.50	.57
Fairfield Fund, Inc.	Perf.	------	------	------	------	------	------	------	------	------	------	------	16	.11	1.10
Farm Bureau Mutual Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	7	.50	.77
Federal Street Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	140	.50	.53
Federated Funds, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	9	.50	.98
Fiduciary Exchange Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	--------	--------
Fiduciary Mutual Investing Co., Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	10	.50	.74
Fifth Empire Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	--------	--------
Fifth Presidential Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	--------	--------
Finance Co. of Pennsylvania	Perf.	------	------	------	------	------	------	------	------	------	------	------	15	.07	.72
Financial Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	1	.50	.65
Financial Industrial Income Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	22	.50	.49
First Fund of Virginia, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	--------	--------
First National Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	2	.50	1.07
First Participating Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	2	.50	1.01
First Security Growth Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	0	.50	.96
Florida Growth Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	6	.50	.95
Foundation Life Stock Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	1	.50	1.24
Foundation Stock Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	0	.50	2.00
Fourth Empire Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	--------	--------
Fund of America, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	44	.50	.93
Fund of America for Equity Income, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	--------	--------
General Exchange Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	--------	--------
General Investors Trust	.500	------	------	------	------	------	------	------	------	------	------	------	18	.50	.73
General Securities, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	2	.50	1.18
Growth Fund of America, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	0	.50	.50
Hampden Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	1	.50	1.30
Imperial Capital Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	26	.50	.82
Imperial Growth Fund, Inc.	.500	------	------	------	------	------	------	------	------	------	------	------	5	.50	1.01

| | | |

ITEM 2—Continued

[Dollars in millions]

Name of fund	1st step		2d step		3d step		4th step		5th step		Final step		Net assets, June 30, 1966	Advisory fee ratio (percent)	Expense ratio (percent)
	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets over—			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
Mairs & Power Income Fund, Inc	0.500	------	------	------	------	------	------	------	------	------	------	------	$1	0.50	0.79
Market Growth Fund, Inc	.750	------	------	------	------	------	------	------	------	------	------	------	0	.75	1.90
Massachusetts Life Fund	.500	------	------	------	------	------	------	------	------	------	------	------	143	.50	.55
Mathers Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	1	.50	.65
Memphis & Shelby County Medical Society, Inc., Investment-Retirement Trust	.500	------	------	------	------	------	------	------	------	------	------	------	4	.50	1.37
Mercer Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	2	.50	.80
Midamerica Mutual Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	8	.50	.63
Morton, B. C., Fund, Inc	.750	------	------	------	------	------	------	------	------	------	------	------	21	.75	.99
Mutual Income Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	1	.50	1.00
Mutual Securities Fund of Boston	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	----	----
Mutual Trust	.900	------	------	------	------	------	------	------	------	------	------	------	10	.90	.90
NEA Mutual Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	8	.50	.67
Naess & Thomas Special Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	7	.50	.28
Nation-Wide Securities Co., Inc	.250	------	------	------	------	------	------	------	------	------	------	------	73	.25	.43
National Educators Mutual Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	----	----
National Industries Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	3	.50	1.00
National Investors Corp	.100	------	------	------	------	------	------	------	------	------	------	------	555	.10	.19
National Western Fund, Inc	.750	------	------	------	------	------	------	------	------	------	------	------	1	.75	3.69
Nelson Fund, Inc	.375	------	------	------	------	------	------	------	------	------	------	------	3	.38	1.36
Neuwirth Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	----	----
New World Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	4	.50	1.00
Newton Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	2	.50	.70
Northeast Investors Trust	.500	------	------	------	------	------	------	------	------	------	------	------	25	.50	.68
Ohio Capital Fund, Inc	.750	------	------	------	------	------	------	------	------	------	------	------	(1)	----	----
Old Dominion Investors' Trust, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	3	.75	1.00
O'Neil Fund	Perf.	------	------	------	------	------	------	------	------	------	------	------	(1)	----	----
Oppenheimer Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	82	1.00	1.58
Park Fund, Inc	Perf.	------	------	------	------	------	------	------	------	------	------	------	0	.50	4.02
Pennsylvania Mutual Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	0	.51	1.39
Peoples Securities Corp	.500	------	------	------	------	------	------	------	------	------	------	------	18	.50	.78
Philadelphia Fund, Inc													71	.50	.69

Pilot Fund, Inc	.500													1	.50	.58
Pinestock Associates, Inc	1.000													(1)		
Pioneer Enterprise Fund, Inc	.500													1	.22	1.17
Planned Investment Fund, Inc	.500													1	.50	2.47
Plico Fund, Inc	.500													1	.50	1.04
Pooled Funds, Inc	.750													(1)	(1)	
Pro Fund, Inc	.380													(1)	(1)	
Provident Fund for Income, Inc	.500													31	.50	.90
Prudential Fund of Boston, Inc		0.500												2	.50	.71
Putnam Equities Fund, Inc		.500												(1)		
Putnam Income Fund, Inc		Perf.												162	.29	.45
Pyramid Investors, Inc		.500												(1)		
Republic Technology Fund, Inc		Perf.												27	.23	1.02
Revere Fund, Inc		.780												4	.78	2.00
Rittenhouse Fund		.500												1	.50	.64
Samson Fund, Inc		Perf.												1	1.55	6.89
Schuster Fund, Inc		.500												(1)		
Scudder International Invstments Ltd		.500												31	.50	.75
Scudder Special Fund, Inc		.500												54	.50	.66
Scythian Fund, Inc		.500												0	.50	3.05
Second Centennial Fund, Inc		.500												(1)		
Second Congress Street Fund, Inc		.500												(1)		
Second Federal Street Fund, Inc		.500												(1)		
Second Fiduciary Exchange Fund, Inc	.500													(1)		
Second Presidential Exchange Fund, Inc	.500													(1)		
Security Diversified Shares, Inc	.500													6	.50	.58
Security Equity Fund, Inc	.500													10	.50	.92
Security Investment Fund, Inc	.500													10	.50	.82
Selected American Shares, Inc	.500													214	.50	.61
Selected Insurance & Financial Equities Trust Fund	.500													8	.50	.50
Shearson Capital Fund, Inc	.500													(1)		
Sherman, Dean Fund, Inc	.250													(1)		
Southwestern Investors, Inc	.500													2	.50	.66
Sovereign Investors, Inc	.500													5	.50	.09
Steadman's Shares in American Industry, Inc	.500													4	.50	1.03
Stein Roe & Farnham Stock Fund, Inc	.500													72	.50	.57
Stein Roe & Farnham International Fund, Inc	.500													12	.44	.67
Sterling Investment Fund, Inc	.500													6	.50	.69
Sunrise Fund Inc	.500													0	.00	.30
Teachers Association Mutual Fund of California, Inc	.500													5	.50	.92
Technical Fund, Inc	Perf.													1		2.29
Templeton Growth Fund, Ltd	.500													5	.50	1.02

[1] No assets.

ITEM 2—Continued

[Dollars in millions]

Name of fund	1st step		2d step		3d step		4th step		5th step		Final step		Net assets, June 30 1966	Advisory fee ratio (percent)	Expense ratio (percent)
	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets up to—	Percent of fee rate	Net assets over—			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
Texas Fund, Inc	0.500	------	------	------	------	------	------	------	------	------	------	------	$81	0.50	0.6
Third Empire Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	------	------
Trans American Fund, Inc	1.000	------	------	------	------	------	------	------	------	------	------	------	1	1.00	1.04
Transatlantic Fund, Inc	.375	------	------	------	------	------	------	------	------	------	------	------	9	.38	.90
Transwestern Mutual Fund	.600	------	------	------	------	------	------	------	------	------	------	------	0	.60	.62
Trustees' Equity Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	------	------
Twentieth Century Investors, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	18	.50	.99
Union Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	(1)	------	------
United Funds Canada-International Ltd	.500	------	------	------	------	------	------	------	------	------	------	------	10	.50	.96
Value Line Special Situations Fund, Inc	.750	------	------	------	------	------	------	------	------	------	------	------	32	.75	1.02
Vanderbilt Mutual Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	2	.50	.65
Vanguard Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	1	.50	1.03
Variable Stock Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	2	.50	.72
Varied Industry Plan, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	9	.03	1.09
Viking Growth Fund, Inc	.750	------	------	------	------	------	------	------	------	------	------	------	2	.75	1.20
Wade Fund, Inc	.750	------	------	------	------	------	------	------	------	------	------	------	1	.90	1.78
Wall Street Investing Corp	.500	------	------	------	------	------	------	------	------	------	------	------	16	.50	.82
Western Industrial Shares, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	4	.45	1.01
Westminister Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	65	.50	.57
Whitehall Fund, Inc	.120	------	------	------	------	------	------	------	------	------	------	------	15	.10	.36
Winfield Growth Fund, Inc	.500	------	------	------	------	------	------	------	------	------	------	------	15	.50	.88
York Fund, Inc	Perf.	------	------	------	------	------	------	------	------	------	------	------	58	2.26	4.10

1 No assets.

[Item 3—Commission's June 30, 1967, index of active registered investment advisers, principal underwriters, sponsors and underlying companies (may be found in committee's files.)]

ITEM 4

INCOME EXPENSES AND PROFITS BEFORE FEDERAL INCOME TAXES OF MUTUAL FUND ADVISORY ORGANIZATIONS FOR THEIR FISCAL YEAR ENDED 1966

[Dollars in thousands]

	Fiscal year ended	Advisory Fees received	Net distribution income [1]	Other income	Total income	Before Federal taxes	
						Profit (loss)	Profit margin (percent)
Channing Financial Corp	Dec. 31	$4,351	$2,460	$343	[2] $7,154	$7	0.1
Distributors Group, Inc	do	1,468	397	32	[3] 1,897	453	23.9
The Dreyfus Corp	do	7,498	3,245	799	11,542	6,886	59.7
Hamilton Management Corp.[4]							
Insurance Securities, Inc	June 30	5,966	6,760	1,614	[5] 14,340	8,803	61.4
Investors Diversified Services, Inc	Dec. 31	19,313	8,131	6,002	[6] 33,446	13,889	41.5
Investors Management Corp	Nov. 30	6,709	2,257	96	[7] 9,062	4,099	45.2
Keystone Custodian Funds, Inc	Dec. 31	7,787	3,035	138	10,960	4,124	37.6
National Securities & Research Corp	do	3,362	959	197	4,518	2,061	45.6
Putnam Management Corp., Inc	do	4,475	3,478	437	[8] 8,391	1,636	19.5
Supervised Investors Services, Inc	Oct. 31	2,085	266	51	2,402	584	24.3
Vance Sanders & Co., Inc	do	1,502	4,686	242	6,430	3,301	51.3
Waddell & Reed, Inc	Aug. 31	9,958	13,840	275	24,074	10,283	42.7
Wellington Management Co	Oct. 31	5,385	1,806	167	7,359	3,650	49.6

Note.—Totals may not add due to rounding.

[1] Distribution income is net of allowances to salesmen agents and dealers.
[2] Does not include equity in net income of unconsolidated subsidiary and net gain on investments.
[3] Includes $25,000 profit on sale of securities.
[4] Not available.
[5] Includes $250,000 gain on sale of options.
[6] Does not include operations of insurance subsidiaries.
[7] Company is a subsidiary of Anchor Corp. These figures include total operation of Anchor Corp.
[8] Does not include operation of Western Travelers Life, an insurance subsidiary.

ITEM 5.—BREAK POINTS IN QUANTITY PURCHASES OF MUTUAL FUND SHARES FOR DETERMINATION OF SALES LOADS CHARGED ON PUBLIC OFFERINGS OF FUNDS WITH JUNE 30, 1966, NET ASSETS OF $100 MILLION AND OVER

[Sales loads are shown as percent of offering price; quantities in thousands of dollars at offering price]

Name of fund (in order of size of first breakpoint)	Percent maximum sales load	1st breakpoint		2d breakpoint		3d breakpoint		4th breakpoint		5th breakpoint		6th breakpoint		7th breakpoint		Final breakpoint	
		Quantity [1]	Percent sales load	Quantity [1]	Percent sales load	Quantity [1]	Percent sales load	Quantity [1]	Percent sales load	Quantity [1]	Percent sales load	Quantity [1]	Percent sales load	Quantity [1]	Percent sales load	Quantity (or more)	Percent sales load
Affiliated Fund	7.5	$5	6.75	$15	5.75	$25	4.75	$50	3.75	$100	2.5	------	------	------	------	$1,000	1.9
American Mutual Fund	8.5	5	8	15	7	25	5.5	50	4	100	3	$250	2.5	$500	2	1,000	1
Investment Company of America	8.5	5	8	15	7	25	5.5	50	4	100	3	250	2.5	500	2	1,000	1
Washington Mutual Investors Fund	8.5	5	8	15	7	25	5.5	50	4	100	3	250	2.5	500	2	1,000	1
Commonwealth Investment Co	8.5	5	8	10	7.5	25	5.75	50	4	100	3	250	2.5	500	2	1,000	1
Eaton & Howard Balanced Fund [2]	7.5	10	7	25	5.4	50	4	100	3	250	2	500	1.5	------	------	1,000	1
Eaton & Howard Stock Fund [2]	7.5	10	7	25	5.4	50	4	100	3	250	2	500	1.5	------	------	500	1
Axe-Houghton Fund [2]	8	10	7	25	6	50	4	100	3	250	2	------	------	------	------	1,000	1
Television-Electronics Fund	8.25	10	7.5	25	5.5	50	4	100	2.5	250	2	500	1.5	------	------	1,000	1
Putnam Growth Fund	8.5	10	7.5	25	5.5	50	4	100	3	250	2.4	500	2	------	------	1,000	1
Putnam Income Fund	8.5	10	7.5	25	5.5	50	4	100	3	250	2.4	500	2	------	------	1,000	1
Putnam Investors Fund	8.5	10	7.5	25	5.5	50	4	100	3	250	2.4	500	2	------	------	1,000	1
George Putnam Fund of Boston	8.5	10	7.5	25	5.5	50	4	100	3	------	------	------	------	------	------	250	2.5
Massachusetts Life Fund	8.5	10	7.5	25	6	50	4.5	100	3	200	1.75	500	1	------	------	1,000	.5
Chemical Fund [2]	8.5	10	7.5	25	6	50	4.5	100	3.5	250	2	500	1.5	------	------	1,000	.9
Colonial Fund [2]	8.5	10	7.75	25	6	50	4	100	2.75	250	2.25	500	2	------	------	1,000	1
Bullock Fund	8.67	10	7.5	25	6	50	4	100	2.75	250	2.25	500	2	------	------	1,000	1
Dividend Shares	8.67	10	7.5	25	6	50	4	100	3	250	2.5	500	2	------	------	1,000	1.5
Fundamental Investors	8.75	10	7.5	25	5.75	50	4	100	3	250	2.5	500	2	------	------	1,000	1.5
Diversified Growth Stock Fund	8.75	10	7.5	25	5.75	50	4	100	3	250	2.5	500	2	------	------	1,000	1.5
Diversified Investment Fund	8.75	10	7.5	25	5.75	40	4	100	3	250	2.5	500	2	1,000	1.25	1,500	1.0
Financial Industrial Fund [2]	8.5	12	7.5	24	6.25	48	4.75	96	3.25	240	2.5	500	2	------	------	1,000	1

Boston Fund	8.5	12.5	7.5	25	5.75	50	4	100	3.25	250	2.5	500	2.25	------	------	1,000	1.75	
Massachusetts Investors Growth Stock Fund	8.5	12.5	7.5	25	5.75	50	4	100	3.25	250	2.5	500	2.25	------	------	1,000	1.75	
Massachusetts Investors Trust	8.5	12.5	7.5	25	5.75	50	4	100	3.25	250	2.5	500	2.25	------	------	1,000	1.75	
Group Securities (3 series)	8.5	12.5	7.5	25	6	50	4.75	------	------	------	------	------	------	------	------	100	4	to 1.
National Securities Series (7 series)	8.5	12.5	7.5	25	6	50	5	75	4.5	100	4	150	3	500	2	1,000	1	
Investors Mutual [2]	8	15	7.5	20	7	25	6	50	4	100	2.5	200	2	400	1.5	700	1	
Investors Stock Fund [2]	8	15	7.5	20	7	25	6	50	4	100	2.5	200	2	400	1.5	700	1	
Investors Variable Payment Fund [2]	8	15	7.5	20	7	25	6	50	4	100	2.5	200	2	400	1.5	700	1	
Channing Shares (2 series) [1]	8.5	15	8	25	6	50	4.5	100	3.25	250	2.5	500	2	------	------	1,000	1	
Hamilton Funds [2]	8.5	15	8	30	7.5	45	7	60	6	75	5	90	4	100	1	5,000	.5	
Fidelity Fund	7.5	25	5	50	4	100	3	250	2.5	500	2	------	------	------	------	1,000	1	
Dow Theory Investment Fund	7.5	25	5	50	4	100	3	250	2.5	500	2	------	------	------	------	1,000	1	
Puritan Fund	7.5	25	5	50	4	100	3	250	2.5	500	2	------	------	------	------	1,000	1	
Selected American Shares [2]	7.5	25	5.5	50	3.75	75	3	100	2	250	1.5	------	------	------	------	500	1	
Broad Street Investing Corp	7.5	25	5.9	50	4	100	3	250	2.3	500	1.8	------	------	------	------	1,000	1	
National Investors Corp	7.5	25	5.9	50	4	100	3	250	2.3	500	1.8	------	------	------	------	1,000	1	
Fidelity Capital Fund	8.0	25	5	50	4	100	3	250	2.5	500	2	------	------	------	------	1,000	1	
Fidelity Trend Fund	8.0	25	5	50	4	100	3	250	2.5	500	2	------	------	------	------	1,000	1	
Wellington Fund	8.0	25	6	50	4	100	2.75	250	2.25	500	1.75	------	------	------	------	1,000	1	
Keystone Custodian Fund K–1	8.3	25	5.75	50	4.25	100	3.25	250	2.5	500	2	------	------	------	------	1,000	1	
Keystone Custodian Fund K–2	8.3	25	5.75	50	4.25	100	3.25	250	2.5	500	2	------	------	------	------	1,000	1	
Keystone Custodian Fund S–2	8.3	25	5.75	50	4.25	100	3.25	250	2.5	500	2	------	------	------	------	1,000	1	
Keystone Custodian Fund S–3	8.3	25	5.75	50	4.25	100	3.25	250	2.5	500	2	------	------	------	------	1,000	1	
Keystone Custodian Fund S–4	8.3	25	5.75	50	4.25	100	3.25	250	2.5	500	2	------	------	------	------	1,000	1	
Dreyfus Fund [2]	8.37	25	6	50	4	100	3	250	2	------	------	------	------	------	------	1,000	1	
Delaware Fund	8.5	25	6	50	4	100	2.75	200	1.5	------	------	------	------	------	------	500	1	
Manhattan Fund	8.5	25	6	50	4.25	100	3.25	250	2.5	500	2	------	------	------	------	500	1	
United Funds (4 series)	8.5	25	6	50	5	100	4	200	3	300	2	------	------	------	------	1,000	1	
Insurance Securities Trust Fund	[3] 8.85	------	------	------	------	------	------	------	------	------	------	------	------	------	------	500	1	

[1] Minimum quantity purchase which entitles an investor to the sales load shown. The quantity appearing under the next break point can be purchased at the lower sales load shown under that break. point.

[2] In determining the sales load applicable to a current purchase, investors may include shares previously purchased and still held.

[3] No reduced sales load.

Note: Represents funds with 87 percent of the assets of all open-end companies charging a sales load.

ITEM 6

TABLE A.—FREQUENCY DISTRIBUTION OF THE NUMBER OF FUNDS BY SIZE AND SALES/REDEMPTION RATIO (JUNE 1966–SEPTEMBER 1967)

[Sales/redemption ratio in percent]

Average net asset size (in millions of dollars)	[1] 0	Net redemption status		Net sales status		Total
		0 to 50	50 to 100	100 to 200	200 and over	
0 to 10	3	3	4	7	11	28
10 to 50	6	7	7	10	16	46
50 to 100	3	3	4	6	11	27
100 to 500	0	3	4	14	15	36
500 and over	0	0	1	8	12	21
Total	12	16	20	45	65	158

[1] Funds which had either no sales, or neither sales or redemptions in the 16-month per od.

TABLE B.—AGGREGATE DOLLAR VALUE (IN THOUSANDS) OF 16 MONTHS' NET SALES, DISTRIBUTED BY SIZE AND SALES/REDEMPTION RATIO (JUNE 1966–SEPTEMBER 1967)

[Sales redemption in percent]

Average net asset size (in millions of dollars)	[1] 0	Net redemption status		Net sales status		Total
		0 to 50	50 to 100	100 to 200	200 and over	
0 to 10	[2] (418)	(2,140)	(165)	2,066	33,369	32,739
10 to 50	(14,265)	(17,265)	(9,973)	9,866	206,303	174,561
50 to 100	(18,298)	(16,774)	(15,044)	50,916	188,515	189,315
100 to 500	0	(30,079)	(29,096)	110,212	641,983	693,020
500 and over	0	0	(44,539)	806,552	1,948,651	2,710,664
Total	(32,981)	(66,363)	(98,817)	979,612	3,018,848	3,800,299

[1] Funds which had either no sales, or neither sales or redemptions in the 16-month period.
[2] Excess of redemptions over sales.

(The following material was submitted for the record:)

STATEMENT OF HAROLD L. BACHE, BACHE & CO., INC., NEW YORK

Many years ago Bache & Co. Incorporated decided that a mutual fund meets the need of many Americans who want to buy common stocks for this purpose but do not have the time and financial skill to make wise choices among the thousands of available stocks, or the capital required to buy the relative protection of an adequately diversified portfolio.

The share of personal savings in this country that has gone into mutual funds over the past decade or two has been influenced by the growing public need for experienced investment help. People with savings to invest have had to seek protection against inflation. Historically, common stocks have provided a hedge against inflation, since they represent participation in the growth and development of the economy.

One major fear that exists duty to the severity of the proposed legislation (S. 1659) is that the number of security dealers able to offer mutual funds may be sharply reduced. In the light of investment success and service to the client, I find it difficult to believe that the need exists for the changes being proposed. A discussion of the most important proposals follows.

SALES CHARGES

The law of supply and demand in the world of personnel and employment demands that highly qualified people receive commensurate remuneration. Registered representatives, as well trained, intelligent and conscientious individuals, are entitled to make an adequate living in the securities field. For the most part, Bache & Co. Incorporated receives 80% of the sales commissions involved in the purchase of a mutual fund with the remainder going to the distributing company.

Since this 80% share, on average commissions, amounts to only 5% of the dollar amount invested, we do not hesitate to state that this figure is economically and morally justified and that the registered representative is fully deserving of his approximate 50% share of this figure. Small orders, involving as little as $100, requiring the same individual handling by Bache & Co. as is given to large orders, constitutes a large percentage of all our mutual fund transactions. These orders involve a substantial amount of time and effort on the part of the registered representatives and service personnel of Bache & Co., in consideration of the commission generated. If these commissions were to be reduced, it would definitely increase the competition that presently exists in the registered representative's business day, necessarily resulting in fewer small mutual fund sales.

If sales charges are excessive as the SEC states, I think our practical experience in our own internal mutual fund sales development program would be quite different. The list of figures below gives the net yearly commissions earned by the average Bache & Co., Incorporated registered representative from total mutual fund sales for the last five years.

Year:	*Amount*
1963	$790
1964	607
1965	1,018
1966	1,253
1967	1,711
5-year average per registered representative	1,075

During this period of time, Bache & Co., Incorporated had an average of about 1,500 registered representatives. If the mutual fund sales of the 25 most successful registered representatives were not included, the figures quoted above would dip drastically. These average figures indicate that registered representatives in the Bache & Co., Incorporated organization do not share the SEC's contention of the lucrativeness of mutual fund sales.

Perhaps the most uninformed argument made against costs is that mutual fund shares involve higher acquisition charges than other types of securities. We feel that there is justification for such higher costs. Shares in mutual funds are *unlike* any other security and are bought and sold differently. A mutual fund share is a participation in a *long-term investment plan.* The principal characteristics of mutual funds are broad diversification of investments and continuous professional management. Open-end mutual funds provide the *only* medium through which millions of investors with limited capital can own shares in diversified portfolios of 50 to 100 or more carefully selected securities under professional investment management with immediate redeemability of their shares at net asset value. Therefore, you can see why it is an extreme oversimplification, albeit true, to say it costs eight or nine times as much to invest $4,000 in a mutual fund as to buy 100 shares of a $40 listed stock. Using the same $4,000 investment, if the investor buys an odd lot or an Over-The-Counter stock, he pays a much higher acquisition cost either in the way of mark ups, or higher sales charges. In addition, he also pays commission for liquidations.

The services provided a mutual fund shareholder also point out clearly the difference between a mutual fund share and a stock. Holders of individual stocks receive no services other than those supplied by the brokerage house through which he makes his purchase. Mutual fund shareholders, on the other hand, have such services as automatic reinvestment of income and capital gains distributions, tax information, plans for periodic withdrawals of cash and the built-in convenience of handling an ownership interest in many stocks through one security.

The investor has a wide range of choice in the price he pays to acquire mutual fund shares. The sales charge depends upon the schedule of charges of the fund and the size of the purchase. All sales charges do not start at 8% or 8½%. One of the largest funds charges 7½% for purchases up to $5,000 and then dips to 6¾% for purchases over $5,000, and as is true for most funds, they do not charge a redemption fee. There are very few services or products that can be brought to the public with mark ups as low as these.

We think it is important to point out that there are over 50 no-load funds available to the public without any sales charge. With such competition, it is inappropriate to seek lower sales charges for funds where sales charges exist.

A study conducted by the NASD in April, 1967, dealing with the impact of the proposed sales charge limitations revealed some startling information. This

study concluded that if the proposed sales charge limitations had been in effect in 1966 it would have decreased the profits after taxes of small broker-dealers (gross income under $100,000) by 179%—of those in the $100,000–$200,000 category by 222%—those under $2.5 million sales by 28%—and those over $2.5 million by 20%. As a result, the smallest firms which represent 64% of all broker-dealers would be forced from a profit to a loss position. I am sure this is not the SEC's purpose but it could still be the result.

MANAGEMENT FEES

We believe it is the prerogative of each management company to set the fees it feels are proper for the services being rendered. Notwithstanding the SEC's contentions to the contrary, the mutual fund management business is an extremely competitive one. In the face of this obvious certainty, it would be totally opposed to the American concept of business to have a federal regulation of prices or charges outside of the utility or subsidized industries.

The SEC's contention that the mutual fund management groups only compete for the dealer's favor and not for the investor's favor misses an important point. Management groups to try to impress upon dealers the merits of their particular funds in the same way that all service industries try to impress the individual dealers handling their product. However, since the funds do not sell directly to the public, but only through dealers they must maintain a close association with these dealers to keep them informed on charges occurring within the funds.

In 1966 the average management fee paid by all mutual funds with assets of $100 million or more (accounting for 80% of the industry's total assets) was 0.37% or $3.70 per $1,000. However, if the investor should so desire, he can select the fund with the lowest management fee. This information is readily available from a variety of publications located in public libraries as well as brokerage offices. However, it is hard to conclude from all the publicity involved in the legislative recommendations that mutual funds with very low management fees are widely available.

The underlying reason for the belief that mutual fund management fees are too high is the argument that since most major banks charge management fees in the area of .06 or .07 of 1% to their trust accounts over $100 million in size, mutual funds should therefore do the same thing. Unfortunately, this reasoning does not take into consideration the fact that a bank, potentially, has many additional sources of income from each trust in addition to the management fee, while a mutual fund has the management fee as its only source of income.

Another item worth noting here is the recent mutual fund started by First National City Bank of New York. It has a minimum investment figure of $10,000 and a ½ of 1% management fee. So, you see, not everyone with investment money being managed by a bank is getting this low .06–.07 of 1% charge as the SEC would lead you to believe.

CONTRACTUAL PLANS

The contractual concept was first pioneered by the life insurance industry and was exceptionally successful in achieving mass distribution of a desirable product—life insurance (it is solely because of the front-end sales charge that an insurance salesman can take time to sit down and sell an individual a $10,000 whole life policy; in most cases, 50%–75% of the total first year's premium goes to the salesman, and approximately 7% of the premium for the next 7–10 years reverts to the salesman as commission). Such is also true of the present contractual mutual fund. Cursory examination reveals that a publicly acceptable precedent exists and is the basis of the contractual concept. For anyone not interested in either of these systems, other possibilities exist: The insurance purchaser can buy term insurance or cheaper bank life insurance where the savings element would still be present but with a lower sales charge; the mutual fund buyer can buy a voluntary plan or no-load fund. I strongly suggest that as long as voluntary plans and no-load funds exist and are widely advertised and publicized, the SEC's idea of rising to the protection of the average investor by complete elimination of contractuals is a disservice that will take its toll by severing all hope of equity investment by a majority of the American population.

While it may be true that the contractual fund buyer would have been better off to have invested in a voluntary plan for the same period of time, the real

question is would he have started his program at all if someone hadn't sat down in his home and convinced him of the merits of the idea? And, if a salesman takes the time and patience and has the investment knowledge and sales ability to sit down and start a family on a regular fund purchase program, does he not deserve some sort of accelerated financial compensation? I feel it is important to realize that as a rule the contractual plan buyer is not a sophisticated equity investor. Margin, leverage, portfolio turnover rate, etc. are not important to him. Rather, he is interested in educating his children or supplementing his social security payments and benefits from the discipline encouraged under the contractual program.

It seems ironical that at a point in time when contractual spending and borrowing is urged upon the consumer from all sides that contractual investing should be so severely criticized. Credit card buying, loan agency borrowing and easy term car financing urge the average American to abandon personal economic and financial restraint. This is all considered part of our way of life.

Is a contractual plan any more of a disadvantage to a person who discontinues it in the second or third year, thus losing a percentage of his money invested, than is a whole life policy which is discontinued in the second or third year before any cash value has accumulated, or the repossession of an expensive automobile after the first year? In each case, a product was purchased with long term intentions but later disposed of after a short period of time, resulting in a financial loss. It is to be hoped that better selling will hold these cases to a minimum in the future.

Since the contractual type program seems to be the only economically feasible way of initiating and servicing small mutual fund accounts, where salesmen visits to the home are required, it is to be hoped that some modification of their first year 50% sales charge—say by spreading this charge over the first three years as one fund is now doing—will be evolved thus resulting in a still better investment vehicle.

In closing, I think it is well to mention that for many years Bache & Co. incorporated has tried diligently to insure that all mutual funds were properly sold and that all mutual fund liquidations were held to a minimum. Each liquidation requires a questionnaire to be completed by the registered representative involved to insure that such course of action was decided upon by the investor after careful consideration and not solicited by our representative.

BACHE & CO., INC.,
New York, November 2, 1967.

Congressman HASTINGS KEITH,
House Office Building,
Washington, D.C.

DEAR CONGRESSMAN KEITH: Thank you for your letter of October 20 in response to my views on the proposed mutual fund legislation.

The matter of no-load funds is a very misunderstood one. As you well know, the management companies sponsoring no-load funds do so for profit. The only difference between load and no-load funds is the manner of distribution; i.e., the former through salesmen (requiring commission), the latter directly from the sponsor.

Bache & Co. Incorporated does not have sales agreements with the sponsors of no-load funds. Let me emphasize at this point that this does not mean we question their integrity or investment acumen. It is just an economic fact of life that we cannot handle a product in which there is no chance of a possible commission or profit.

If a customer asked one of our R.R.s about investing in no-load funds, our salesman would attempt to interest the customer in an appropriate load fund if he felt the customer should be investing in funds in the first place. Failing in this, he would probably supply the customer with the address of one or more no-load funds with information to the effect that these funds can only be purchased directly from the sponsoring organization.

Our R.R. could supply the growth record, expense ratio and other readily available statistical information on a particular no-load fund but he would not go into other factors such as depth of management, investment philosophy, etc., since we, as a firm, do not maintain close liaison with these funds and are not prepared to give and maintain information of this nature. When a customer becomes a

client by purchasing a mutual fund (or any other security for that matter), we feel it is our responsibility to stay well informed on the fund and management company so that at any time in the future we would be able to give an accurate recommendation to that particular client on the advisability of maintaining, decreasing or increasing his investment in that fund. In effect, we are put on retainer as financial advisors whenever anyone buys a mutual fund through us. This would be an impossible responsibility to fulfill with regard to no-loads since we do not keep in close touch with them for the reason stated above.

Therefore, to answer your last question, our salesmen could not be compensated for any effort expended on their part to help a customer purchase a no-load fund.

Generally speaking, no mutual fund should be purchased on the merits of its performance alone. However, for the most part, this is exactly what happens when an investor buys a no-load fund. He has very little understanding of the investment philosophy underlying portfolio changes, recent management changes that could possibly effect future investment results and, particularly for the large investor, of general stock market and economic conditions which should be the underlying factors upon which all investment decisions are based. In reality, it takes a sophisticated individual to examine the prospectus and literature of different no-load funds to choose the one best suited to his objectives.

We think the salesman plays a very important role in helping people select the proper investments—including the choice of the appropriate mutual fund. It is a generally accepted tenet of business life that you should not accept legal or medical advice through the mail. We have found this to be a wise philosophy in the investment field also.

If you should desire clarification on any of my comments or if you think there are any other areas in which I may be helpful, please do not hesitate to let me know.

Sincerely,

HAROLD L. BACHE,
Chairman of the Board.

STATEMENT OF FINANCIAL SERVICE CORPORATION OF AMERICA

SUMMARY

While we realize that our industry, like any other industry, can be improved, we are convinced that the proposed S.E.C. legislation is drastic in nature and would have very serious consequences on our business and on the investing public.

1. The elimination of contractual plans designed to compensate a salesman for selling relatively small monthly plans would:
   A. Drive many salesmen out the business and attract virtually none to the business.
   B. Remove one of the soundest methods of accumulating money now available to the American public.
2. The reduction of the maximum sales charge on cash mutual fund sales from 9% to 5% would:
   A. Force some investment dealers out of business.
   B. Force other investment dealers to merger into bigger companies.
   C. Force many remaining investment dealers to concentrate on trading accounts—getting customers interested in buying and selling stock frequently—rather than on selling mutual funds to their customers. We believe that for many investors this would not be to their advantage.

DISCUSSION OF FINANCIAL SERVICE CORPORATION OF AMERICA'S POSITION ON S.E.C. LEGISLATIVE PROPOSALS

We have observed in working with several thousand individuals over the past 8½ years that most of them are not good investors.

We have also observed that the temptation to spend money—rather than save and invest it—is great. So great, in fact, that many people never accumulate over a few thousand dollars. This is frequently true, not only of those with moderate incomes but also those with high incomes. Somehow as the income rises the outgo rises to match it.

Because of the above we believe that mutual funds—to help the individual manage his money—and the mutual fund salesman—to convince him of the desirability of saving and investing—are a desirable part of the American economy.

Mutual funds offer the investor an opportunity, at reasonable cost, to have full-time professional investment men selecting his stocks for him. The results achieved by most of the funds have been excellent. There has been a net flow of money into mutual funds in each of the past 8 years. At the same time, there has been a net flow of money *out of* common stocks by individuals. This seems to indicate that the investing public more and more recognizes the value of professional investment help as offered by mutual funds.

We believe that the legislative proposals of the S.E.C. would have a very damaging effect on this industry that seems to be accomplishing so much for the American investor.

Here are the three primary recommendations of the S.E.C. and the position of Financial Service Corporation on each:

1. Reduce the maximum sales charge from 9% to 5%

The S.E.C. compares the cost of buying mutual funds with the cost of buying individual stocks on the New York Stock Exchange. They say that even 5% is substantially more than the N.Y.S.E. commission. This is true. However, individual stocks are bought and sold with great frequency by many investors. Mutual funds—by their very nature of providing a dynamic management of money are bought with the idea of *holding many years*. Because there is usually no need for the investor to change his investment in his funds, there is not the repeat business on the same money in mutual funds as there is in individual stocks.

The retail dealer in mutual funds has costs of operations similar to distributors of other products. Large office staffs must be maintained. A sales staff must be maintained. These are necessary to provide the investor the service that he needs and deserves.

Even if the retail dealer received the full 9% that could be charged—this is not a very big mark-up on a product. How many businesses are there who mark up their product only by that amount? The furniture business marks its product up 100%. Mark-ups of 40% and 50% are common to cover the cost of distribution in America.

As a practical matter the maximum sales charge made by the funds varies from 7½% to 8½%. The retail dealer receives only about 75% to 80% of this—or about 6%. Also the mutual funds offer discounts for larger purchases. For example, a typical breakdown of cost to the investor and % to retail dealer would be:

Amount invested	Percent of sales charge	Percent to retail dealer
Up to $24,999	8.0	6.0
$25,000 to $49,999	5.0	4.0
$50,000 to $99,999	4.0	3.7
$100,000 to $249,999	3.0	2.4
$250,000 to $499,999	2.5	2.0
$500,000 to $999,999	2.0	1.6
$1,000,000 or over	1.0	.8

In 1966 *Financial Service Corporation received only 4.4% on all funds sold.* This is *gross*. From this the salesman must be paid and the office staff for proper investor service to be maintained. Frankly, it is very difficult to make a reasonable profit on this small percentage.

The S.E.C. says that if the sales charge is reduced that more people will buy mutual funds and thus sales will increase and perhaps so would total income to the industry. We are not at all sure this is so. In any event, we feel that mutual funds are still going to have to be sold and serviced. There simply must be enough mark-up to accomplish this. We believe that if it is reduced *any* from its present level that the business will become so marginally profitable—if profitable at all—that it would be unattractive for firms to remain in the mutual fund business.

2. *"Elimination of contractual plan"*

The S.E.C. position is that the contractual plan should be eliminated. This is the plan whereby the investor sets a specific goal for himself to invest periodically, usually monthly, until he reaches that goal. The cost that he pays on this investment if he reaches the goal is about the same as if he made a lump-sum investment. On the smaller plans, it is a little greater and on the larger plans it is a little less. However, he pays more of his costs the first year than he pays in subsequent years. The amount of costs paid in the first year is usually about 50% of his investment (although in larger plans it becomes smaller than this). His costs in subsequent years is usually about half of the regular charge of say 8% so that in the end his costs would come out to be around 8%.

The S.E.C. would like to eliminate these plans in order to protect those who buy them and then, for one reason or another, sell out before the fund has had an opportunity to produce a profit for them. We agree with them in that it would be desirable if no one ever took a loss on his investment plan. However, if this plan is eliminated, it is going to eliminate the only opportunity that many Americans will have to accumulate money in a sound way, through mutual funds.

For example, one mutual fund sponsor who has been selling contractual plans for many years presented these figures. From the years 1949 through 1965, 225,000 plans were effected. Of these, 202,000 had profits amounting to $211 million. Twenty-three thousand had losses of $4 million. The average loss per account was only $178. Isn't it unreasonable to kill a system that, as shown in the above figures, has produced profits of $211 million dollars just to save losses of $4 million? Another important reason we believe the contractual plan should continue is simply to encourage the salesman to sell as many members of the American public as possible on thrift and investing in the American economy. This is a difficult job. Look at what the salesman has to go through in order to accomplish his mission and earn commissions. He must get an appointment with a man whom he believes has the ability to save some money. In times as busy as these this in itself is quite time-consuming. He must find out the situation of the individual—if he is in a position to invest. Then usually, if the individual is interested, he has the salesman sit down and explain it to both him and his wife. After the investor buys, the salesman must continue to stay in touch with him to have any administrative errors corrected, and over the years to continue to encourage him to invest.

As you might imagine, all of this takes many hours and in some cases many days to accomplish. If it were not for the contractual plan, for every $100 a month customer, the salesman would receive only $4 on that $100 invested. This would be $4 a month, but as you can see he would have to sell a great many of them in order to make a living. This simply is not enough in earnings for the amount of hard and creative work involved. He simply could not make a living in the business without the contractual plan.

But, of even greater loss than this would be the fact that millions of Americans would not be given the opportunity to accumulate money, a little at a time, on a monthly basis, in ownership of American industry. The contractual plan in mutual funds is probably the best opportunity that millions of them will ever have to become financially independent—to depend on themselves rather than someone else—particularly, the government.

3. *The S.E.C. wants the authority to regulate management fees to be sure that they are "reasonable"*

Financial Service Corporation is not directly engaged in this phase of the business. However, it is difficult for us to understand why in a very competitive business such as mutual funds a government agency should control the amount of profits made. The mutual funds business is far from a public utility type of operation. There are over 200 funds, each competing with each other for the business with the investing public in America. Why not let competition control the management fees that are charged?

If General Motors is alert enough and smart enough to make the kind of car the public wants to buy, we do not believe the government should control their profit per car. Competition should control this. Why isn't the same true in mutual fund management companies? If a fund can manage the public's money so well that they continue to want to buy it, why shouldn't their profits be greater than the funds that are not as alert and able? Isn't this the essence of the dynamic qualities of the American free enterprise economy?

In conclusion, the mutual fund industry in America seems to be serving its clients well. It provides a sensible way for most Americans to invest in stocks. The investment is for the long-term. The commission is received only once. Yet the service must continue. This must be taken into account when evaluating the cost of purchase. The investment must be sold and therefore the salesman must receive enough compensation to keep them in the business. The competition is great among funds and therefore the competition should control what the managers receive rather than the government.

We at Financial Service Corporation agree with the paragraph on the December 6, 1966 *Wall Street Journal* editorial entitled "A Little Too Active."

"The danger here is that if Congress does everything the S.E.C. wants, it may not merely be producing more equitable fees and practices. It may succeed in making the industry unprofitable or so marginally profitable as to be unattractive. In that event, the whole industry, the investor and the whole economy will suffer."

STATEMENT OF INVESTORS MUTUAL, INC., INVESTORS STOCK FUND, INC., INVESTORS SELECTIVE FUND, INC., AND INVESTORS VARIABLE PAYMENT FUND, INC., MINNEAPOLIS, MINN.

Gentlemen, the following views with respect to subject bills are submitted to the Committee by Investors Mutual, Inc. (Mutual), Investors Stock Fund, Inc. (Stock), Investors Variable Payment Fund, Inc. (Variable), and Investors Selective Fund, Inc. (Selective) (collectively "Funds") of Minneapolis, Minnesota. These funds collectively have assets totaling in excess of $6 billion, about 1 million shareholder accounts and represent approximately 15% of the mutual fund industry.

I. GENERAL PROVISIONS

A. Independence of fund directors

Section 10 of the Investment Company Act of 1940 presently requires that registered investment companies using a principal underwriter for distribution of its securities must have a *majority* of its board of directors composed of persons who are not "affiliated persons" of such principal underwriter. A lesser ratio is required with respect to the investment adviser. At the present time, and for some years prior hereto, the boards of directors of subject Funds have been substantially more independent than these statutory minimums. This independence has been legitimate in fact and in practice, and has resulted in two negotiated reductions in the advisory fee in addition to the first reduction in 1963. The present 12 man boards of the Funds are each composed of 10 directors who are independent of IDS and 2 directors who are affiliated with IDS, its principal underwriter and investment adviser.

We consider that most fund activities which the SEC considers to be abuses would be alleviated if they would support measures to increase and insure the *independence* of the Fund Directors. We were greatly surprised when the SEC Report did not recommend strengthening the independent directors. To this end we suggest amending the Investment Company Act as follows:

(1) Require that the *chief executive officer* of the Fund be unaffiliated with the adviser or underwriter.

(2) At least 80% of all Fund directors to be unaffiliated with the adviser or underwriter.

(3) The insertion of a provision to insure truly independent directors along the following lines:

"No person affiliated with, in control of, or affiliated with any person in control of any adviser or underwriter for any registered investment company, shall directly or indirectly, suggest, direct, counsel, cause, command, induce, procure, recommend or in any way attempt of influence the selection of any unaffiliated director of any investment company with which such adviser or underwriter is affiliated and all directors affiliated with such adviser, underwriter or person in control thereof shall be ineligible to vote upon the election of any director who is required to be unaffiliated."

B. Compensation to directors, officers and employees

The amendment to Section 15(d)(1) proposes, *inter alia*, that (1) *advisory fees* of mutual funds and (2) all compensation of fund *"officers asd directors"*, etc. should be judged by a legislative standard as to whether they were *"reason-*

able" and *that the SEC would be empowered to sue in court to enforce its position in this area.* In claimed support for these two proposals the SEC points out that under the existing court decisions *advisory fees* are now judged by a "*waste*" standard. The SEC also claims that this is a different rule of law than normally prevails for other corporations. (Actually it is the *same rule of law* that applies to all corporations that have contracts approved by their shareholders.) However, apart from the legal situation with respect to "advisory fees", *as to fund officers and directors, no claim is made by the SEC that a different rule of law is applicable to their compensation than is applicable to the compensation of corporate executives generally.* Thus, the reason the SEC claims as justification for changing the law to have "advisory fees" judged by a different standard *has no application to compensation of fund "officers and directors".* (Compare Technical Statement of SEC pages 1–10). We accordingly suggest that H.R. 9510–9511 be amended at page 20, lines 2 and 4, to strike the words "officer, director" where same appear.

Many of the complaints of the SEC really constitute a criticism of the services rendered by some Fund directors. This could be remedied by good directors, but if H.R. 9510 is passed in its present form, it is our opinion that it would increase the difficulty of obtaining good directors for the Funds because the statute would encourage suits by the SEC against them over their compensation by a different rule of law than applies to corporations generally. We consider this to be an unreasonable provision. Various legal restrictions now make it difficult to get good directors. The Federal Reserve Act prohibits all bank directors from serving as directors of open end Funds. The Investment Company Act restricts the ability of Investment Bankers to serve as fund executives. (See Sec. 10 (b)(3).) Many brokers and dealers are not candidates for Fund directors because they desire to sell securities to the Funds. (See Sec. 10(b)(1) of the Investment Company Act.) Thus, the area of eligible Fund directors is narrow and we hope Congress will not restrict it further by unreasonably encouraging litigation against directors and officers over their compensation.

C. Breach of fiduciary duty

Heretofore the SEC could take action against an officer, director or affiliated person of a mutual fund if he were guilty of "gross misconduct or gross abuse of trust". It is now proposed to change this standard and to authorize the SEC to take action against such persons if there is any "breach of fiduciary duty". What is a "*breach of fiduciary duty?*" This standard practically defies description. It is not a sufficiently definite standard upon which to base a violation of the act. "A fiduciary relationship" extends to *every possible case* in which there is confidence reposed on one side and resulting superiority and domination on (the) other. *Warren* v. *Pfeil*, 346 Ill. 344, 178 NE 894, 900.

If the practically unlimited power to intervene in what they consider "breach of fiduciary duty" cases is given the SEC, under their interpretation practically anything that a person does that they consider should not have done or should have been done differently in a corporation they would consider to be a "breach of fiduciary duty". No showing has been made that there is any substantial wrongdoing in these mutual fund companies. Hence, it is submitted, there is no reason to change the present standard. If violation occur the present act is sufficient for the purpose. In our opinion the proposed amendment to Section 36 would confer too much power based on too indefinite a standard. The proposed standard is vague and uncertain. We recommend no change in this section of the statute. *If any amendment is made to this section it should be fashioned on the lines of the pattern Congress provided with respect to Banks and Savings and Loan Associations in dealing with a similar problem in the Financial Institutions Supervisory Act of 1966 (80 Stat. 1028).* An amendment as follows is suggested:

"SEC. 36. The Commission is authorized to bring an action in the proper district court of the United States or United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting as officer, director, member of an advisory board, investment adviser, or depositor, or as principal underwriter, if such registered company is an open-end company, unit investment trust company, or face-amount certificate company, has in such capacity been guilty within five years of the commencement of the action or is about to engage in any act or practice, in respect of any registered investment company for which such person so serves or acts, *constituting a breach of fiduciary duty and (1) that the company has suffered or will*

probably suffer substantial financial loss or other damage or that the interests of its shareholders could be seriously prejudiced by reason of such violation or practice or breach of fiduciary duty, and (2) that such violation or practice or breach of fiduciary duty is one that involves personal dishonesty on the part of such director, officer or person or will operate as a fraud upon the company or its shareholders."

D. Affiliation of fund officers

For some purposes such as voting on advisory and underwriting contracts, according to some arguments, it is claimed that an officer (President) and director of a Fund who is *completely unaffiliated with the adviser or underwriter* must be considered the same as a director *affiliated* with the adviser and underwriter because he is an officer of the Fund and that the President of the Fund is prohibited from voting on the advisory and distribution contracts. If such construction is correct it is wrong in principle because the Preisdent is probably the most knowledgeable person on the subject. We consider that if the president or officer of the fund company has *no affiliation* with the adviser or underwriter he should be permitted to vote on such vital matters as advisory and underwriting contracts. It is not logical to place independent directors in the same boat with nonindependent directors and disqualify the independent directors the same as the non-independent directors when the independent directors have absolutely no conflict of interest. The statute should be based on a distinction made between (1) persons affiliated with the *Fund*, and (2) persons affiliated with the *adviser or underwriter*. This could be accomplished in one respect by amending Sec. 15(c) of the Act to read as follows:

"* * * (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such *adviser or underwriter*, or (2) etc."

E. Fund holding companies

The proposal designed to restrict Fund Housing Companies from investing in shares of other funds (See 12(d)(1)) would prevent IDS (a registered investment company) from investing for its pension and retirement plan in shares of funds managed by it. We suggest that a *statutory exemption* allowing such transactions be added to any amendment on this subject.

F. Interested persons

The proposed Section (19) defining "Interested Person" in (A) (iii) and (B) (iv) has a three year retroactive provision with respect to any person who has had any "direct or indirect material business or professional relationship with such investment adviser". The agreement between the SEC and the ICI Task Force also applies to certain persons in such capacities who have been within that classification within the past two fiscal years of the company. Such *ex post facto* application of the law is too broad and is also unfair. *It would seem to be sufficient if such provisions were restricted to persons who have any such prohibited relationship* following the enactment of the bill.

Also, the definition of "member of the immediate family" seems too broad—to the extent it includes persons who are *not* members of the immediate family. Including "brothers and sisters" is clearly too broad and it is submitted that on children the bill should be limited to those children who are in *locus parenti*. Why should any person be penalized for conduct of persons who are beyond their control and from whom they have no right to obtain information? It would be sufficient if the SEC after notice and hearing could decree such persons to be interested.

As the bill states that common directorship does not give rise to interested person category, *we suggest that common "officers" should be placed in the same category or that the bill be amended to provide exceptions from interested person classification for persons who* "by reason of being a common director *or officer* of any other investment company having the same investment adviser or principal underwriter." (Amend. (A))

G. Deferred effectiveness of management fee legislation

We submit that a two year period would be necessary to adjust management contracts to the requirements of this legislation—rather than one year.

H. Adviser furnishing information to funds

The proposal to amend Section 15 (C) (lines 15–21) to require advisers and underwriters to furnish certain information which the Funds need in negotiating

contracts to the Funds has a loophole in it, in that if an adviser and a Fund wrote a contract *solely* for investment advice (and not for any housekeeping services) the Fund would only be able to compel information from the adviser with respect to investment advice. Our Funds have no difficulty heretofore in obtaining such information from IDS, but if the bill passed in its present form, IDS would not be required by law to furnish data with respect to services (other than investment advisory services) furnished under a separate contract. Since the advisory services are the smaller part of such contracts, this could constitute a serious barrier to getting *all* the information needed to negotiate for all services. *We suggest that this section of the bill be corrected so that advisers and underwriters would be required to furnish statistics with respect to all services, investment advisory and housekeeping, if requested.*

I. Short term trading

If it is considered that short term trading by highly speculative funds is a hazard the SEC has authority to compel special disclosure in the prospectus pointing out the turnover of portfolio securities, and the hazards involved, if hazards they be. If this is a problem it should be dealt with directly and not used as a bogeyman in an attempt to support other legislation that is unrelated to short term trading. (cf. Senate Hearings, p. 65–66.)

II. MANAGEMENT FEES

A. Basis for determining reasonableness of management fees

The bill proposes to amend Section 15 to provide that the fees of the investment companies be *reasonable according to a legislative formula* that may have other factors added thereto. See proposed amendment to Section 15(d)(2). We are for reasonable fees but the proposed standard allegedly designed to accomplish this we considered to be one sided and not practical. In our statement to the Senate Committee we set forth the nature of our objections to the manner in which the SEC proposed to define the word "reasonable" in H.R. 9510–9511. (See Senate Hearings p. 1183–1185). In his statement to the House Committee Chairman Cohen of the SEC said with reference to this matter.

"* * * *somehow the bill and our accompanying language at least worried some people as to its scope. So the suggestion was to eliminate the specification of those particular factors, and make it perfectly clear that the court would consider any factor which was relevant in reaching any determination of reasonableness. Now, if this would serve to alleviate some concern in this area, while I have not taken this up with the Commission as such, we had some discussions about it. I am convinced that this is an area in which the Commission would be most sympathetic.*"

It is concluded from the statement of Chairman Cohen that it is in order to *strike proposed Section 15(d)(2) as same appears on pages 20 and 21 of H.R. 9510–9511* and renumber the remaining subsections (3), (4), (5) and (6) as subsections (2), (3), (4) and (5).

We also oppose the proposal to authorize the SEC to initiate fee litigation against mutual fund companies. If it could be worked out we would not oppose a provision *authorizing Funds to have such matters determined by the courts in a proceeding in the nature of a declaratory judgment.*

B. Separate statement of management fees

H.R. 9510 proposes that the consideration for *investment advice* be separately stated from the consideration received for all other services covered by the advisory contract. (H.R. 9510, Section 15(a), page 17, lines 19–21). We fail to see any benefit to the Fund shareholders in this proposal. The SEC proposal for separate statistics will do away with twenty-seven years of experience and the whole industry will be launched on a statistical program that will require many years to furnish a base of experience for future decisions.

It is our opinion that the *expense ratio* of the Fund is the more important factor and that the fees would be better evaluated when considered in relation to *total services furnished*, hence, we oppose a requirement that a statement of the consideration for investment advice be separately made. We suggest, accordingly, Section 15(a)(1) of the Act be not changed.

III. SALES LOAD

A. The 5% proposal

What about the proposal to amend Section 22(c)(1) to reduce the sales load about 50%? Is this proposal good or bad for the Fund shareholders? The present sales load of Fund shares varies greatly. There are about 34 "no load" funds. Sales charges of some other funds go up to 8¾%.

The proposed cut to 5% for the sales charge is an extreme proposal. The philosophy behind it is also extreme. The proposal is that the fee should be fixed by law and by the rules and regulations of the SEC. Why? No substantial profits by the underwriter or their salesmen are being made out of this distribution. The fees are not the subject of illegal agreements. Nobody is profiteering from the present scale of fees. The fact that Fund shares can be bought for "no load" or as high as 8¾% indicates complete freedom in the field. Why then should Congress fix a fee? Congress might well be justified, as other legislative bodies have been, in prohibiting grossly *exorbitant* commissions but we see no justification for Congress fixing the day to day commission for all Funds and then empowering the SEC to fix it even lower. We do not see that any case has been made for fixing the day to day commission for all funds and then empowering the SEC to fix it even lower. In a few states people can buy life insurance from a savings bank at a low sales charge, or buy it from a life insurance company and pay a more substantial sales cost even in excess of that charged by most mutual funds. Should all life insurance companies be compelled to change to the lower sales charge imposed by savings banks sellers of life insurance? What is there then in the mutual fund situation that calls for fixing a sales charge for mutual funds below that which is now producing a loss or a slight profit at best?

B. Inconsistency of SEC proposal to cut sales commission

Through the 34 years that the SEC has administered the Securities Act it has constantly encouraged the training and upgrading of the sales forces of investment companies and securities brokers and dealers and in the Securities Act Amendments of 1964 Congress passed extensive legislation to further this policy. Partially as a result of such policies and to a considerable extent on its own independent initiative, IDS at very considerable expense has created a sales force for the sale of Fund shares that is composed entirely of full time salesmen and all are fully trained in the sale of Fund shares. We consider the proposal of a 50% cut in commissions to be contrary to the best long term interests of the Fund shareholders because their ability to meet normal redemptions would be hazarded.

Such far reaching changes should be based on adequate information which the Commission did not present. This is apparent from the December 2, 1966 Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Growth to the Committee on Interstate and Foreign Commerce (House Report No. 2337):

"Such a reappraisal (of the practices and procedures in the securities markets [1]) *requires fuller data* concerning the securities holdings and trading patterns of institutional investors than is now available. While this information can be obtained by the Commission with respect to investment companies, there is a lack of reliable and comprehensive data concerning the securities holdings and trading activities of most other types of institutional investors, including pension funds. *Closing this informational gap is an indispensable step to adequate analysis of the problems raised by the institutionalization of the stock markets.*" (page 26)

The stated purpose of this bill is to arrest the growth of mutual funds because of some conversations "with people in the securities industry, with executives of listed corporations and with students of the markets", (Senate transcript p. 66) and others.

It is asserted that "* * * there is a mounting public disquiet about some of the market implications of the greatly accelerated Mutual Fund growth * * *." (Senate transcript p. 66)

It is submitted that the foregoing does not set forth a legitimate legislative purpose and is not a proper substitute for "closing the informal gap" on the basis of adequate facts.

Also, there is no showing that the growth of mutual funds is as large as that of "pension funds, equity investments by insurance companies, * * * assets

[1] Matter in parenthesis supplied.

managed by banks and other professional trustees and types of investment companies other than Mutual Funds * * *". (Senate Record, Page 66). In fact on June 30, 1966 the total assets of just four banks in the United States exceeded the total assets of the entire mutual fund industry:

	Billions
Bank of America	$15,619
Chase Manhattan	13,597
First National City Bank of New York	12,588
Manufacturers Hanover	6,849
Total	48,653

During the House hearings some statements tended to assume that mutual funds were the persons causing the increased institutionalization of the market. Actually there is no showing that they are other than a small part of it.

Mention was made in the Senate hearings that Federal Savings and Loan Associations made no sales charge, but further inquiry would have disclosed that in their last record year they spent a total of *$122 million in advertising and this was the shareholders' money.* This is part of their "sales charge" and the cost is a continuing one.

C. SEC proposal will work adversely to present law

If the drastic proposal to cut the sales charge by 50% is adopted it will also work in a manner contrary to the objective that Congress expressed in the 1964 legislation. The greatly reduced sales compensation could not do anything other than *lower the quality of solicitation.* The recruitment, training and compensation of these salesmen to meet the high standards imposed by the company and the statute has been costly. In the past 27 years IDS has distributed on the average over $186 million worth of our Fund shares yearly and the profit after taxes to IDS from such distribution has average only $276,000 per year. Should such minimal profits be attacked?

If the sales charge is reduced as proposed in H.R. 9510 we feel it would interfere with our ability to contract for full time, high grade, highly trained salesmen; for skilled sales investigators; for high standards for acceptance of new business; for continuous customer servicing and for free transfers between affiliated funds, all of which we consider to be most desirable.

D. Section 22(d). An anti-rebate provision

Much mention has been made of Section 22(d) and it has been claimed that it is an anti-trust provision prejudicial to a free market and that nothing like it exists elsewhere. One SEC witness even went so far as to contend that this created a "monopoly". (See testimony of Prof. Wallich.) Nothing could be further from the truth. This provision merely requires that all shareholders who buy the same mutual fund on the same day pay the same price; i.e., the "current public offering price described in the prospectus". Each fund is free to choose the commission to be paid and these vary widely from no-load to about 8¾%. Nothing in the law prohibits a shareholder from selling his shares at any price he chooses. Section 22(d) is thus in effect an Anti-Rebate provision with respect to the sales commission. It is a provision against fee splitting. It prohibits discrimination against purchasers of mutual funds. *Every state in the union has a similar provision* prohibiting rebate of any portion of the sales commission paid on any life insurance contract. Both laws are designed to guarantee against salesmen discriminating in favor of one purchaser as against another. 22(d) exemplifies exactly the same legislative purpose for mutual funds that the Anti-Rebate provision of the State Insurance Laws supply for life insurance.

The North Carolina law is a good example, it prohibits:

Insurance Laws of North Carolina. 58–54.4(8). *Rebates.* "* * * offering to rebate * * * any rebate of premiums on the contract * * *."

Such laws are of long standing in the insurance industry. See Appendix "A" for list. These laws are designed to protect the public by giving a "fair shake" to *all* purchasers of life insurance. The purpose of 22(d) of the Investment Company Act of 1940 is the same; i.e., to guarantee that fund shares sold to each shareholder on the same day are sold at the *same price* and that there is *no discrimination* against shareholder applicants, that there is no rebate of sales commissions and that all applicants are treated alike.

Thus, there is no reason to repeal 22(d) unless it is desired to make it possible for discrimination to exist daily in the sale of the same mutual fund and there

is a desire to permit mutual fund salesmen to offer a rebate of all or a portion of the sales commission as an inducement to purchase mutual fund shares. Persons who think such practices are desirable differ from the 1940 Congress that enacted 22(d) to prohibit these well recognized evils.

One purpose of this anti-discrimination provision is to guarantee that the fund receives in cash the full net asset value on the date of the sale. If this did not result existing shareholders of the fund would be discriminated against.

E. Comparison to stock exchange firms

The bill is an attempt with reference to the sales charge to *cast the distribution of Mutual Fund shares in the same mold as transactions in stock on the stock exchanges.* It is true that a number of stock exchange *brokers* have established mutual fund departments and have salesmen specializing in the sale of mutual funds, but a very substantial portion of shares of mutual funds are sold by *direct selling organizations* wholly unrelated to stock exchange brokers. But the mutual funds that are sold by stock exchange firms are usually sold in an entirely different manner from the manner in which those firms conduct their stock exchange operations. Thus, the fact that some stock exchange brokerage houses sell mutual fund shares outside the stock exchange, in addition to their regular stock exchange business, is no justifiable reason to regulate the sale of mutual fund shares in a comparable manner to stock exchange transactions. These sales operations are two entirely separate businesses with completely different attributes and should be so considered by the Congress.

F. Distinctions from stock exchange operations

The usual sale of a mutual fund share is a more complex and time consuming operation than the sale of shares on the stock market by a stock broker. The structure, portfolio, investment objective and restrictions, sales load and other material features of each fund is complex and requires considerable explanation to each applicant. *Federal laws, in effect, require that the sale of a mutual fund share be a more expensive operation than the sale of a share on a stock exchange.*

The mutual fund business is entirely different from the sale of listed stock on exchanges. It is more similar to the sale of life insurance but a mutual fund sale *by law* requires more explanation than is required by law even for insurance material features of each fund is complex and requires considerable explanation quires much more explanation and understanding than the purchase of ordinary shares of stock. The duty of clearly explaining the investment is placed upon the salesman, most of whose sales in our company, which comprises about 15% of the industry, are made by direct contact, by direct sales in the home or office. *Why should the compensation of a mtual fund salesman who makes most of his sales by personal solicitation on the basis of a prospectus that must be fully explained in detail in the prospect's home or office, be restricted to the same compensation as is received by a stock broker who sits at his office telephone most of the day and takes orders for listed stocks.* To require similar compensation for these dissimilar services would not be fair or reasonable. One requires more work than the other. Also, most mutual fund purchases are long term investments while stock exchange securities are held for relatively shorter periods of time. The stock exchange broker has more turnover and he gets a commission *both* on the purchase and sale of a listed stock. *Our mutual fund salesmen receive no commission for, nor is any charge imposed on, the redemption or transfer of our fund shares to any of our other funds.* At the present rate all shares listed on the New York Stock Exchange turn over completely in 5.2 years on the basis of last year's sales when 10 billion shares were listed and 1,809,351,000 sold (see New York Stock Exchange Fact Book, 1966) and trading is up this year. The salesman of listed stocks on the stock exchange is the beneficiary of this heavy turn over.

G. So-called self-regulation

In the hearings there has been some mention of self-regulation with respect to the sales charge of fund companies as an alternative to the drastic reduction to 5% maximum as requested by the SEC. The term "*self-regulation*" is misleading in the context in which it has been used in the hearings. Some believe that it means industry regulation "*without* government interference." (See remarks at lines 13–15, p. 600, typewritten transcript, House Hearings, October 17, 1967.) Others use the term to mean industry regulation of the NASD type "*with* government interference." Actually "self-regulation" of the NASD type is similar to

what Metternich said about "non-intervention," i.e. that "*non-intervention* was a political and military term that meant the same thing as *intervention*." Thus some of the proponents (Mr. Haack) are using the term "self-regulation" when what they actually refer to is "*self-regulation that may be not self-regulation*," since it is *outside* regulation by the SEC in the last analysis, with the SEC having authority to abrogate the "self-regulation" of the industry. Thus, this confusion of terms exists. The dialogue on this point has been referring to different things without precise definition. One is talking about pure industry self-regulation and the other is talking about giving the SEC an absolute right to abrogate the self-regulation of the industry. These are exact opposites.

It is our view that self-regulation which confers power on the SEC to override industry self-regulation would be very hazardous and unwise in view of the already expressed opinion of the SEC in favor of the cut to 5% which they presently propose. With the SEC holding such views, the mutual fund industry could look forward eventually to having the SEC carry out their 5% proposal. For reasons previously stated with respect to the SEC's proposal to cut the sales charge to 5%, we consider that same would not be in the best interests of fund shareholders whether it was brought about directly by legislation or indirectly by the SEC through mis-called "self-regulation."

We also consider it inadvisable to have the sales charges of the mutual fund industry controlled in the first instance by what are essentially stock brokers oriented to Stock Exchange firms. Their basic business is so different and foreign to the sale of mutual fund shares in the form of direct sales and by contractual plans that the two should not be mixed.

That the NASD style of so-called "self-regulation" is not true *self*-regulation is readily apparent from the following provision of NASD provision in the Securities Exchange Act of 1934.

"*Sec. 15A. (k) (1) The Commission is authorized by order to abrogate any rule of a registered securities association, if after appropriate notice and opportunity for hearing, it appears to the Commission that such abrogation is necessary or appropriate to assure fair dealing by the members of such association, to assure a fair representation of its members in the administration of its affairs or otherwise to protect investors or effectuate the purpose of this title.*"

The leverage of such power can be used to accomplish such SEC objectives as a 5% sales charge, even if the industry's "self-regulation" did not so provide in the first instance.

CONCLUSION

The basic question that is presented to Congress by the SEC proposals in H.R. 9510 is whether the proposed radical changes in the mutual fund business are warranted by any facts disclosed in the SEC Report to Congress and the testimony before the Committee. The very drastic and revolutionary changes proposed should certainly not result from presumptions and mere expressions of personal opinions, and especially in the area of mutual funds, which by the wording of the same Report have been operated in an honest and proper manner to the benefit of millions of investors. The SEC Report states, *inter alia*:

(*P. VIII*)—"* * * on the whole investment companies have been diligently managed by competent persons and that the general record of the industry is one of which it can be justly proud."

(*P. 1*)—"In this report the Commission finds that on the whole the investment company industry reflects diligent management by competent persons."

(*P. 1*)—"Under the guidelines established by the Act the investment company industry has acted responsibly to provide a useful and desirable means for investors to obtain diversification of investment risks and professional investment management."

(*P. 71*)—"The investment company industry has attracted many men of high professional competence and integrity because of their efforts and because of the salutary provisions of the Act serious abuses in transactions between investment companies and their affiliated persons have been reduced to a minimum."

It is submitted that there is nothing in all the present studies and reports that justifies such violent changes as are proposed in H.R. 9510–9511.

The wide public satisfaction with the mutual fund industry, as evidenced by its continued growth with full disclosure, does not indicate that the public is complaining. At the Senate hearings Senators stated that they had received no demands for such drastic legislation and members of the House of Representa-

tives have made similar statements. *In fact, no person has disclosed any widespread demand for any of this legislation.*

When a prospective investor considers purchasing a mutual fund he considers the sales commission and the management fee together which are prominently printed on the front page and repeated elsewhere in the official prospectus. *He knows how much he is undertaking to pay in each category—sales and management.*

The only conclusion one can reach is that the SEC proposal to reduce the sales charge is *clearly designed to reduce the sales of mutual fund shares.*[2] We believe it would have that effect. (And we now know it is intended to have that effect.) In our own mutual funds, contract negotiations are certainly carried on as arm's length transactions. The investment advisory and the distribution contracts are continuously studied by a Special Committee of independent members of the Board of Directors, which makes reports and recommendations to the entire Board. In such studies, they take into consideration all elements that should be considered and this has resulted in bargaining negotiations with the investment adviser and distributor. We believe that any *independent* Board of Directors of mutual funds should and will resort to this same extensive study and will review these matters and negotiate the contracts in the best interests of their shareholders.

The officers and directors of our Funds, as we believe is true of other mutual funds, firmly believe that our mutual fund shares offer an exceptionally fine investment media for the small investor, and this apparently has been the conclusion of the SEC as indicated by their foregoing quotations. We do not think that any law should be passed that would be prejudicial to mutual fund shareholders or to prospective mutual fund shareholders. Any effort that would set such fees by law or permit the SEC to set them would be to completely discredit not only the business judgment but in some respects the integrity and honesty of the officers and directors of the funds, and if such would cause small investors not to be approached and have mutual funds explained to them or would cause redemptions by existing shareholders, it would certainly in our opinion be against the public interest.

In the SEC Report and the Senate and House hearings, no evidence is given of any extensive research in the area of sales and sales charges of mutual funds to justify the recommendation that has been made. On the other hand, facts show that mutual fund salesmen are now well-trained and informed (at considerable expense), that they are making an honest but certainly not an exorbitant income from such sales,[3] and that the distributor of our funds has actually operated at a loss from underwriting in some years and made small profits in others.

We submit that no proper legislative purpose has been shown to justify the principal changes proposed in the bill (see Senate Transcript of Hearings at pages 65 and 66). The SEC admits that no study has been made to justify the proposals to reduce commissions. Consequently, *the effect of this legislation is speculative* and the consequences cannot be predicted.

Appendix "A"

Insurance Anti-Rebate Statutes

The following is a citation to the principal Insurance Anti-Rebate Statute in each of the 50 states and the District of Columbia:

Alabama Insurance Code, Title 28, § 90(4)(8); Alaska Statute § 21.36.100; Arizona Statute § 20–449; Arkansas Statute § 66–3005(8); California Insurance Code §§ 750, 751; Colorado Statute § 72–14–4(10)(a); Connecticut Statute Chapter 676, § 38–59; Delaware Statute, Title 18, § 534(8)(A); District of Columbia Code Annotated, § 35–715; 18A Florida Statute Annotated § 626.0611 (1960); Georgia Statute § 56–704(8)(a); Hawaii Statute, Chapter 181, § 643(h); Idaho Statute § 41–1314; Illinois Statute Annotated, Chapter 73, § 763; Burn's Indiana Statutes, Section 39–5304(A)(8); Iowa Code Annotated, Title XX, Chapter 507B, Section 4(8); Kansas Statutes Annotated 40–2404(8); Kentucky Revised Statutes, Section 304.932; Section 1214(A)(8), Title 22, Revised Statutes of Louisana; Section 2905(8), Chapter 25, Title 24, General Statutes of Maine;

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[2] This was first written before this fact was confirmed by oral testimony at Senate hearings. (See pages 65–66 of typewritten Senate Hearings, S. 1659, July 31, 1967.)

[3] See Senate Hearings, p. 65.

Article 48A, Section 224, Annotated Code of Maryland; Section 4(a)(8), Chapter 176D, Annotated Laws of Massachusetts; Michigan Statutes Annotated, Section 24.12024; Minnesota Statutes Annotated 72.13; Mississippi Statutes § 5681; 19 Missouri Statute Annotated, § 375.936(8) (Supplement 1966); Montana Statute § 40–3510; Nebraska Statute § 44–361; Nevada Statute, Title 57, § 686.160; New Hampshire Revised Statute Annotated, § 417:4(8); New Jersey Statute Annotated, § 17:29B–4(8) (Supplement 1966); New Mexico Statute § 58–9–12(8); New York Insurance Law § 209; Section 58–54.4(8), General Statutes of North Carolina; Section 26–30–04(8), Revised Code of North Dakota; Section 3901.21(G), Ohio Revised Statutes, Annotated; Oklahoma Statutes Annotated, Title 36, Section 1204(8); Oregon Revised Statutes, Section 739.540; 40 Purdon's Pennsylvania Statutes Annotated, Section 275; Section 27–29–4(8), General Laws of Rhode Island; Section 37–1213(3), General Statutes of South Carolina; Section 31–13–16, South Dakota Code; Section 56–1204(8), Tennessee Revised Statutes; Section 4(8), Article 21.21, Vernon's Civil Statutes Annotated; Section 31–27–14, Utah Code Annotated; Section 4724(8), Title 8, Vermont Statutes Annotated; Code of Virginia, Section 38.1–52(8)(a); Revised Code of Washington 48.30.140; Section 33–11–9, Michie's West Virginia Code; Section 207.04(1)(h), Wisconsin Statutes; Section 26–158(8)(a), Wyoming Statutes.

STATEMENT OF NORMAN ABRAHAM, PRESIDENT, POOLED FUNDS, INC.

Mr. Chairman and members of the committee, my name is Norman Abraham. I am the founder and President of Pooled Funds, Inc., one of the two existing registered investment companies which has an investment policy contemplating investment in the shares of other mutual funds. Mr. Milton Mound, President of First Multifund of America, Inc., the other such fund, has already appeared before you. Each of these funds would be in effect abolished by the proposed changes to Section 12(d) of the Investment Company Act of 1940.

On pages 311 through 324 of its Report, the SEC proposed legislation which would "prevent the creation and operation of fund holding companies". By giving funds of this type that name, the SEC was obviously attempting to equate them to the public utility holding companies whose operations were, for good and sufficient reasons, severely controlled and regulated by the Public Utility Holding Company Act of 1935. The name so given by the SEC is, of course, completely misleading, since a public utility holding company necessarily operates by virtue of control of subsidiaries, whereas a fund of this type is already limited by law to holding not more than 3% of the outstanding stock of other investment companies, or 5% in the case of certain "specialty" companies.

I will attempt to establish that not one of the dangers cited by the SEC in its Report is actually applicable to either fund of this type presently registered and that legislation can be passed which would obviate any such dangers in future funds of this type without abolishing them.

The first danger cited by the SEC is that funds of this type will control portfolio mutual funds. The Report admits that such control is very difficult in the case of domestic investment companies in view of the 3% and 5% limitations. However, it is indicated that affiliated funds might be created each of which could invest up to such limits. Pooled Funds, Inc., has undertaken to the SEC that no such affiliated funds will be created, and is in accord with the suggested compromise which has been presented to the SEC which would extend the 3% limit to all affiliates. We also support the provisions of the proposed compromise which would prohibit us from voting shares of portfolio funds except in the same proportion as all other shareholders so vote, and from redeeming more than 1% of an underlying fund's outstanding shares during any period of less than thirty days. These provisions of the proposed compromise completely solve any problem which there might have been in relation to control of portfolio funds or sizable redemptions of underlying funds in the case of adverse market conditions. In our case, we also expect to be able to minimize the problem, without any legislation, by switching, without sales load, portfolio funds held by us to other more conservative funds in the same group in the event of adverse market conditions.

The next danger cited by the SEC is that there are two layers of advisory fees. Pooled Funds, Inc. meets this problem by reducing its advisory fee by the advisory fees of its portfolio funds. First Multifund of America, Inc. meets the

same problem by the use of a contingent fee, which depends on the fund beating the Dow Jones Industrial Average. The SEC also suggests that there is a layering of administrative expenses. This is a fact, but it is offset by other factors not mentioned by the SEC; it is much less expensive to operate a fund of this type than to operate a normal mutual fund, as it will not be necessary to maintain the large research department which is necessary for most mutual funds. It may also be expected that any increase in administrative expenses will be more than made up by the savings in sales charges which necessarily will be enjoyed by investors in these funds.

The last danger cited by the SEC is that of double sales loads. Pooled Funds, Inc. has no sales load, and First Multifund of America has a sales load of 1½%. We support the provisions of the proposed compromise which would limit sales loads to 1½%. Not only would this solve the double sales load problem cited by the SEC, but experience indicates that funds having no or a small sales load generally do not reach the large size achieved by some mutual funds having sales loads. Thus, even if a number of new funds of this type were to be formed, the impact on the industry could be expected to be negligible.

The SEC Report then attempts to indicate that funds of this type have no utility as an investment vehicle. The problem is stated by the SEC in terms of diversification of underlying portfolio securities which, of course, is not the diversification achieved by a fund of this type. A purchaser of mutual fund shares is not purchasing an interest in a portfolio; he is purchasing management. A holder of shares of more than one fund receives the judgment of the managers of each fund, not just that of one management. As the Report itself notes, most mutual fund investors agree wih this concept. The Report states (page 207): "Moreover, a majority of mutual fund investors hold shares in more than one fund."

The SEC then argues that funds of this type will not be able to invest in only the best performing funds but, if they grow big enough, will have to go to the second best. The difficulty with this argument is, of course, that what is the "best" mutual fund is not necessarily an easy matter to determine. Should that fund be considered best which has performed the best in the past six months, one year, three years, or five years? What about funds which have consistently performed well in rising markets, but poorly in declining markets? In short, there is no such thing as a few "best" funds with all the others being second best.

The final SEC objection is that a fund of this type can avoid investment restrictions by investing in funds which do not themselves have such restriction. This argument, of course, ignores the fact that a domestic fund of this type must continuously have in effect, to sell its shares, an effective prospectus disclosing these matters.

In its attempt to paint as black a picture as possible of funds which invest in other funds, the SEC does not in its Report point out the advantages to *investors* of such funds. There are at least three major advantages to investors of these funds over the conventional mutual fund.

The first advantage has already been briefly discussed, namely, that a fund which invests in other funds provides directly to an investor that which most mutual fund investors have attempted to provide for themselves: diversification of portfolio management. As noted above, most mutual fund investors hold shares in more than one fund, for the simple reason that most people do not wish to trust all of their investment money to any one management. A fund which holds several funds not only provides directly this advantage sought by most mutual fund investors, but is in a much better position than such investors carefully to watch management performance on a continuous basis.

The second advantage of a fund which invests in other funds is that the selection of a particular mutual fund or funds for purchase is not, at the present time, an easy or simple one. In any rational selection of a mutual fund to be purchased, there must be weighed not only the past performance of various funds, but also the relative amounts of sales loads, advisory fees, whether or not there is large unrealized depreciation in the portfolios, and the expense ratios of the various funds. Other factors would include whether or not dividends or distributions may be reinvested at asset value, whether or not there are other funds in the same group having a conservative investment policy to which the investment may be switched without sales load in declining markets, and whether or not the fund provides various shareholder services, such as periodic investment at a level load through a bank custodian. In addition, there are today more and

more new types of investment companies coming into existence, and the advantages and disadvantages of each must be carefully weighed before an informed decision may be made. These new types of investment companies include funds with power to "leverage" by borrowing, funds having the power to sell short and to deal in puts and calls, funds which engage in relatively heavy trading to take advantage of short-term changes in market conditions, and funds which have a portion of their portfolios in unmarketable or other "restricted" securities.

In short, the decision as to which fund or funds to purchase today is not a simple one even for an informed investor.

A final important advantage of a fund which invests in other funds is that such a fund provides a medium through which investors may purchase fund shares at a lower sales load than would otherwise be available. This is even more true with funds of this type having no or a very small sales load. The SEC Report itself states on page 206 that: "The reduced loads charged on substantial purchases of fund shares benefit some investors. For a few very large investors the benefits can be substantial. However, the relatively slight reductions available at the initial breakpoints are far beyond the reach of most investors." A fund which purchases and holds shares of other funds, though, is in a position to take advantages of breakpoints not available to investors in those funds. Thus, the total overall sales loads paid by an investor in a fund of this type may be expected to be much lower than if an investor had purchased directly shares of one fund or several funds.

A careful reading of the SEC Report as to "fund holding companies" makes it quite clear that this portion of the Report is basically an attack on Fund of Funds Limited, a foreign fund of this type. It is only by a very careful reading of this section that the reader is able to understand that most of the evils attributed to this type of fund are not applicable to domestic registered investment companies or, in particular, to Pooled Funds, Inc. or First Multifund of America, Inc. We are really small innocent bystanders who may be mortally wounded by a battle between the giants. I respectfully request this Committee not recommend the enactment of the amendments to Section 12(d)1 of the Investment Company Act as proposed by the SEC, but that it enact such amendments only if there is included therein a compromise proposal relating to funds of this type (a copy of which is attached), which compromise proposal I firmly believe would fully eliminate any possible future dangers and would permit the continued existence of an investment vehicle which has great advantages to investors.

PROPOSED AMENDMENT TO SECTION 7 OF S. 1659 (COMMITTEE PRINT) DEALING WITH REGISTERED FUND HOLDING COMPANIES

Section 12(d)(1) of the Investment Company Act as proposed to be amended in Section 7 of the Committee Print of S. 1659 is further amended by redesignating subparagraphs (—) and (—) thereof as subparagraphs (G) and (H) and inserting immediately after subparagraph (E) thereof a new subparagraph (F) to read as follows:

(F) The provisions of this paragraph (1) shall not apply to securities purchased or otherwise acquired by a registered investment company if—

(i) immediately after such purchase or acquisition not more than 3 per centum of the total outstanding stock of the issuer of such issuer is owned by such registered investment company and any affiliated person of such registered investment company,

(ii) such registered investment company has not offered or sold after July, 1968 and is not proposing to offer or sell any security issued by it through a principal underwriter or otherwise at a public offering price which includes a sales load of more than 1½ per centum.

No issuer of any security acquired by a registered investment company pursuant to this subparagraph (F) should be obligated to redeem such security in an amount exceeding 1 per centum of such issuer's total outstanding securities during any period of less than thirty days. No such investment company shall exercise voting rights by proxy or otherwise with respect to any security acquired pursuant to this subparagraph (F) except in accordance with instructions from its security holders or in the same proportion as all other holders of such security exercise such voting rights.

STATEMENT OF DANIEL J. BAUM,* PROFESSOR OF LAW, INDIANA UNIVERSITY

An Institutionalized Market: The Impact Upon Mutual Funds

I

What may properly be called the special report of the Securities and Exchange Commission on mutual funds is a compromise.[1] It is not an attempt to recommend those changes reasonably necessary to insure for the future adequate protection of fund shareholders, free securities markets, and proper safeguards in the funds' relations with portfolio corporations. The report attempts to meet present needs generally in terms of minimal remedies.[2]

But perhaps this is not unwarranted. The special report is, after all, a report not of the Commission's staff, but of the Commission itself, a body of five individuals, each with his own values, his own interpretation of the facts which are admittedly complex.[3] In such a context the report of the Commission should not be condemned but praised. It has both integrity and vigor. Yet, this should not deter full inquiry into the state of the industry as the Congress intended when it authorized the Commission "at such times as it deems that any substantial further increase in size of investment companies creates any problems involving the protection of investors or the public interest to make a study and investigation * * * and from time to time report the results * * * and its recommendations to the Congress." [4]

II

We begin with fundamentals. A mutual fund purchases securities.[5] Its ability to find and exploit investments successfully depends in no small measure on the actions of the underlying portfolio company and other security holders in that company. To test the behavior of mutual funds, to determine how they are fulfilling their statutory responsibilities, we must understand the implications of what the Commission acknowledges, namely, the growing institutionalization of the stock market.[6]

None would argue that institutions dominate the market. However, none should dispute the influence of institutions in specific major issues and industries. Consider the facts. In the aggregate institutional investors, which include mutual funds, pension funds, trusts, insurance companies, are a mighty force. To illustrate, the Wharton Report studied a mutual fund industry from the period 1952–1958 when assets jumped from $3.9 billion to $12.2 billion. The mutual fund industry of 1966 was more than triple the size of that in 1958.[7] Similarly, "the $105.8 billion of equity securities held at yearend 1965 by financial institutions was almost four times the $28.2 billion held at the end of 1955.[8]"

The monies flowing to the institutions are not scattered. Rather, they are invested in relatively few issues listed on the New York Stock Exchange. Measured not in terms of outstanding stock, but rather trading volume how imposing is the position of institutional investors. In New York Stock Exchange study for March 10, 1965 "the trading volume of institutional investors and intermediaries was the highest recorded since the (NYSE) transaction studies began.

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[1] The report represents an attempt at Commission level to provide an evaluation of the investment company industry. Though the study has depth, it is a compromise. See, "The Prosecutors and the Judges", Fortune, December, 1966, 165, 210: "The details of the SEC's new mutual-fund study * * * were handled by a small group on the staff who gathered data, argued fiercely among themselves as to recommendations the study should make, and wrote drafts of all the chapters. But there was then some extremely heavy editing by the commissioners, who did not agree with all the recommendations of the staff—and also had a lot to argue about among themselves."

[2] SEC Report on the Public Policy Implications of Investment Company Growth, 89 Cong., 2d Sess., 6 (1966), hereafter referred to as Report. See also, text discussion under IV.

[3] It must be emphasized that the report is one of recommendations to Congress. It is addressed to a political body. By definition the report has limitations. In his letter transmitting the report to Congress Chairman Cohen noted, "Neither the Special Study nor the Wharton report was a report by the Commission. When those reports were published, the Commission undertook to evaluate the public policy questions that they raised. * * * This report is a result of that undertaking." Report at ix.

[4] Section 14(b), Investment Company Act of 1940.

[5] See, Hopper, "Antifraud and Disclosure Reuirements in Selling Investment Company Securities," CCH Conference on Mutual Funds, 15 (1966).

[6] Report at 275. See also, Baum and Stiles, The Silent Partners: Institutional Investors and Corporate Control (1965).

[7] Report at 275.

[8] Id. at 277. Included in this figure are the equity securities held by mutual funds.

The investors accounted for an estimated 31.4 percent of the total round-and odd-lot share volume during that day." [9]

Without becoming enmeshed in a statistical morass let us remember one additional fact: When we speak of institutional investors, we are focusing upon relatively few mutual funds and banks. Like so many aspects of our economy, institutional investors also have a propensity toward concentration. "In the mutual fund industry * * * decision-making power is highly concentrated. Eight advisory organizations control about half of the industry's assets." [10] A survey by the Commission's staff found that 20 large banks manage nearly half of all noninsured private pension fund assets.[11]

Applied to specific issues, addressing ourselves only to investment companies, we begin to understand more fully the implications of investment company growth. Combined holdings of 425 investment companies totaled $8 billion in 30 issues at yearend 1964. In nine of the 30 stocks investment company holdings amounted to 10 percent or more of the outstanding shares. "Trading activity of the investment companies in many of these stocks during the last half of 1964 was particularly significant with *net* purchases amounting to as much as 39.3 percent of NYSE trading volume in the shares of Southern Pacific Co. and 34.9 percent of such volume in the shares of Union Carbide Co. In 13 of the 30 stocks net purchases or sales amounted to 10 percent or more of NYSE volume during that period, and for 7 of these stocks it exceeded 20 percent or more." [12]

The special report on mutual funds conceded that not only do investment company holdings account for a substantial portion of the outstanding stock in particular issues, but their holdings in particular industries can be significant. 78 companies, representing approximately two-thirds of the assets of all investment companies, held more than 10 percent of five major aerospace companies. In Lockheed Aircraft Corporation alone their holdings amounted to 17.3 of outstanding common stock, and in Northwest Airlines, Inc., 29 percent.[13]

From what has been stated the Commission concluded that institutions can contribute to shaping the market: "The growing institutionalization of the securities markets tends to make the markets for the issues in which institutional investors are significant more susceptible to sharp, sudden and erratic price fluctuations. As the irregular and relatively infrequent transactions of institutional investors in sizable blocks of securities becomes more and more significant and the relative importance of broad streams of smaller 100-share orders from individual investors dwindles, the auction markets find it increasingly difficult to maintain the high degree of depth, liquidity, and continuity which they have traditionally sought to achieve. Even when a large institutional investor makes a conscious effort to avoid upsetting the market by adhering to gradual programs of accumulation or disposition, its activities tend to have a marked effect on the prices of the securities involved." [14]

It is in this setting that the Commission recommended no "major new legislation" as a result of the institutionalization of the market. Rather, the agency urged that the informational gap be closed "with respect to pension funds and other institutional investors through amendments to existing Federal regulatory statutes and through other appropriate means. * * *" [15]

We do not quarrel with the Commission's recommendations. We do ask, however, if the market is institutionalized, don't certain results necessarily flow immediately to investment companies?

III

Elsewhere in the Commission's report on mutual funds we are told that the larger the fund the greater is the tendency to invest in relatively few stocks."

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[9] Id. at 279. In 1965 institutional purchases and sales of common stock reached the highest volume ever recorded. Although 1965 also was a year of record trading activity in the securities markets, generally, institutional trading in recent years has increased at a much greater rate than overall trading volume. Id. at 278.

[10] Id. at 301. In mid–1966 the assets managed by the three largest advisers constituted 28.5 percent of all mutual fund assets. The $5.2 billion in mutual fund assets managed by IDS constituted 13.5 percent of total industry assets. Ibid.

[11] Ibid. It should be noted that these same banks manage assets for other institutional investors and for personal and common trusts.

[12] Id. at 291.

[13] Id. at 293.

[14] Id. at 301.

[15] Id. at 303.

(A)t the end of their fiscal year 1964, despite substantial net capital inflow between 1958 and 1964, half of the 10 (largest) funds had reduced the number of common stock issues held by them from the number held at their fiscal yearends 1958. The largest fund, Investors Mutual, Inc., reduced its holdings by 37 percent from 208 to 131 issues. The largest reduction was 44 percent—from 165 to 92—for Fidelity Fund, Inc." [16]

Based on fund activity *alone* we are also told that the ability to both buy and sell is hampered when size reaches a given level and a limited investment policy is pursued. Examples, though dated and therefore understated, were not lacking in the report. A fund manager for a complex authorized in September 1962 the purchase of 443,000 shares of a company for two funds under its management. By March 1963 less than half the purchase order of one fund and less than 10 percent of that of the other had been filled. During this period the price per share had increased from $40 to $48.[17]

But perhaps even more alarming is an example given on the sell side. An advisor for one of the largest funds spotted unfavorable factors affecting one of their portfolio securities. A decision was made to sell 220,000 shares when the market stood at $57 a share. (In this regard it should be noted that the report does not indicate whether the 220,000 constituted all that the fund possessed of the questioned issue.) However, before the fund's "selling program" could be effected the price per share had dropped to the midforties.[18]

If mutual funds were pension funds, there might be less reason to be disturbed. If mutual funds could buy for long-term holding, there might even be benefit in the rapid absorption of the floating supply of stock. But mutual funds are not pension funds. They are subject to the demands that are imposed by their own internal and industry structure.

The mutual fund industry is concentrated and dominated by billion-dollar enterprises. The structure of a mutual fund generally requires it constantly to sell fund shares in order to meet redemptions. In turn, the sales effort in no small way is financed by the give-up device resulting from brokerage. Add to this the need to sustain a given distribution "policy" and we can better understand the pressure on mutual funds to trade. They, unlike pensions funds, cannot anticipate with any precision the demands that will be made upon the entity.[19]

Now couple these facts with that of an institutionalized market. What is the meaning for mutual funds? How important to fund shareholders, to free securities markets, and to relations with portfolio corporations is the impairment of portfolio mobility and flexibility? The Commission stated: "Should the growth of the largest funds and fund complexes continue these funds might soon reach the point—relative to the size and conditions of the markets and the economy—where their portfolio mobility would be so seriously impaired as to affect gravely the interests of their shareholders. It is indeed possible that the future investment experience of the largest funds, even if their sizes were to continue near the present levels achieved only recently, might be so affected. This is underscored by the fact that other institutional investors, pension funds in particular, have also enjoyed phenomenal growth and are contributing to the growing problems of portfolio mobility. For these reasons, questions pertaining to large fund size and to the need for maximum size limitations on individual funds and fund complexes must be reexamined periodically in the context of the changing conditions in the securities markets and the economy." [20]

IV

The difficulty with the Commission's position is that in a very real sense the future which it fears already is here. Taking the facts as given, without any thorough analysis of institutional behavior, we know that *because of size* mutual funds now cannot exercise their best judgment. They can neither buy nor sell

[16] Id. at 295–96. The Dreyfus Fund, Inc. and National Investors Corp. were identified in the Wharton Report as having more than 40 holdings of one percent or more of the outstanding voting stock of portfolio companies on September 30, 1958. Id. at 295. See also, Report at 255.

[17] Id. at 256.

[18] Ibid.

[19] With the development of the fund of funds how much more difficult is the position of mutual funds. The threat of massive redemptions is not one to be taken lightly. Id. at 299.

[20] Id. at 263.

when prudence dictates. The implications of mobility and flexibility made rigid for the mutual funds has a bearing on many of the recommendations of the Commission.

A. Size limitations

Awaiting the results of study yet to be undertaken the Commission made no recommendations respecting size limitations on mutual funds. Investment policy may continue as it has. All that is provided from the point of reality is found in the five-percent-rule already in the Act.[21] Any company five percent or more of the outstanding stock of which is held by an investment company will be treated as an affiliated person of that investment company. In the words of the Commission "this definition is significant because most transactions between investment companies and affiliated persons require prior Commission approval. Such approval can be granted only if the Commission finds 'that the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned.'" [22]

Neither portfolio rigidity nor portfolio control are prohibited by the Act. Surely, however, there is a need to do more than simply study. Isn't portfolio rigidity in view of the present industry structure itself unhealthy? Ought we not concern ourselves at the very least with controls over the dollar amount that any mutual fund complex may invest in any single issue, keeping in mind the standard not of outstanding shares but trading volume? This suggestion is not intended in any way to criticize the Commission's evaluation of give-ups, which, if accepted, might ease somewhat the pressure to trade for the sake of generating brokerage. The point is that the Commission might not have gone far enough. The danger signs clearly are present. Why wait until substantial injury results?

Should portfolio rigidity be permitted to solidify, then we must recognize that for many purposes investment companies may become locked into given issues, that is, there may not exist the opportunity to sell a "locked" issue with relative ease and without substantial loss. Are we not therefore compelled to ask how the shareholders of the mutual funds will be protected by the managers of their monies? We are assuming a not unreal situation where unfavorable factors in a portfolio company require sale, and the fund because of the size of its holdings simply is not in a position to extricate itself.[23] At this point the import of the Commission's Investment Trust Study in *1940* should be reviewed:

"Investment companies may serve the useful role of representatives of the great number of inarticulate and ineffective individual investors in industrial corporations in which investment companies are also interested. Throughout the course of the exstence of such industrial corporations, various problems are presented to their stockholders which require a degree of knowledge of financial and management practices not possessed by the average stockholder. Investment companies by virtue of their research facilities and specialized personnel are not only in a position to adequately appraise these situations but also have the financial means to make their support or opposition effective. These investment companies can perform the function of sophisticated investors, disassociated from the management of their portfolio companies. They can appraise the activities of the management critically and expertly, and in that manner not only serve their own interests but the interest of the other public stockholders." [24]

To argue that investment companies do not possess sufficient control to sway management will not suffice. Some mutual funds do hold sufficient stock to make their views felt.[25] But, quite aside from percentage of outstanding stock, let us not forget that portfolio management for a number of reasons, including stock options, has an interest in not seeing any substantial block of stock sold in a way that will depress the market price of that company's issue.

To answer as the Commission has that other institutional investors share the same problem as mutual funds is not to respond full or fairly.[26] It is the

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[21] Section 2(a)(3), Investment Company Act of 1940.

[22] Report at 308.

[23] Id. at 256. Further, the Wharton Report found that the three largest fund groups had 338 separate holdings consisting of one percent or more of the voting shares of a portfolio company. Over half of these holdings exceeded two percent. Id. at 308.

[24] Id. at 310.

[25] In 1958 individual funds possessed 10 percent or more of the voting stock in 34 different issues, and five to nine percent in five others. Id. at 308, note 7.

[26] Id. at 310–11.

same as saying: "If X commits a harmful act, Y should be permitted to do the same." It relegates all to the same common denominator. Further, it ignores the facts. Mutual funds, not pension funds, are the more active traders, and consequently suffer the most from a rigid portfolio position. And, it must be emphasized, mutual funds have a history of government regulation which has given to them the imprimatur of a quasi-fiduciary in the eyes of the fund shareholders.

B. Fund shareholders

There is a premium paid by those who invest their monies in mutual funds. Some would call it a premium for experience; others would term it a payment for safety; both are correct. Indeed the Commission report does not deny the premium; only the amount is brought into question. We believe the Commission has recommended too little; it has not faced an underlying problem: Fund shareholders, particularly in the larger funds for reasons already stated, may not be getting either the benefit of experience or safety. How can they? If a fund manager in the exercise of his experience business judgment spots weak factors in a portfolio holding and decides to sell but cannot because of the amount held, surely the fund shareholder suffers. **Can it be denied that in such a situation the fund shareholder is in much the same posture as one who holds for speculation? His fund manager hopes for investment growth, but is limited in what he can do to insure it; the securities ride the wave of chance.**

V

The Commission's report makes a fundamental assumption: The structure of the mutual fund industry is basically sound. The agency's recommendations are designed to improve that structure. The thrust of these comments questions the Commission's basic assumption.

STATEMENT OF ERNEST L. FOLK, III, PROFESSOR OF LAW, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL*

I. COMPENSATING MANAGERS AND ADVISORS OF INVESTMENT COMPANIES

(Section 8 of the Investment Company Amendments of 1967, amending Section 15 of the Investment Company Act of 1940)

Section 8 of the Investment Company Amendments of 1967 deals with the critical problem of the level of management fees charged by investment advisors and principal underwriters to the mutual funds which they serve under contract. The proposed rewriting of Section 15(d) imposes a statutory standard of "reasonable" compensation, impliedly grants a private right of action to enforce the standard, and places the burden of demonstrating reasonableness upon the objector. I favor enactment of this provision with one reservation.[1]

1. I first point out that the proposal is a very moderate one. First of all, it declares, in the context of mutual fund management fees, a criterion which has been universally applied to compensation of managerial personnel in corporation law, namely that aggregate compensation must be reasonable and reasonably related to the services performed for the paying entity. It is hardly radical to suggest that such a well established standard of fairness should explicitly apply to mutual funds as well. Secondly, the proposal is designed to overcome the effect of several decisions which have invoked certain restrictive rules of state corporation law so as to make it extremely difficult to give effect to a "reasonableness" test. It seems to me quite appropriate that in a field, subject to comprehensive *federal* regulation, Congress should adopt federal rules whose prime purpose is to undo limitations derived from state corporation law which are primarily relevant to entirely different sorts of enterprises. Finally, the proposal places upon the objector the burden of proving reasonableness by a "preponderance of evidence that such compensation is unreasonable." Although I think this unduly favors management.

I cite it as a clear instance of the bill's notable restraint in regulating advisor-underwriter fees. The conservatism of the proposal is further underscored by

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*The views presented in this statement are personal and should not be attributed to the University of North Carolina or to its School of Law.

[1] *Infra*, pp. 803–804.

the fact that neither the bill, nor the SEC's report, would effect any change in the unique structure of the externally managed mutual fund. Accepting that structure as it has developed over the years, the bill would only employ moderate and protective safeguards against abuses, both demonstrated and potential.

2. Reasonableness of fees—Existing law

The sequence of litigation challenging the advisory fee charged many mutual funds by their advisor-underwriters is well known. Few of these decisions went to final judgment, although many were settled with some downward revisions of the fees. Litigation under state law standards is demonstrably inadequate to the risk of insuring fair and reasonable fees in the industry. These decisions, coupled with the facts found by the Wharton and SEC Reports demonstrate the need for congressional intervention. This, I believe, is shown by the state law standards employed by the courts in testing the levels of the fees.

(a) *Judicial Views.*—Absent shareholder ratification, courts diverge on the validity of a transaction between a corporation and a director, officer or controlling person; but the probable majority view is that the transaction stands if it is found to be fair (upon judicial scrutiny) and was approved by a majority of directors having no direct or indirect interest in the transaction. If shareholders ratify the transaction, despite some variance among the courts, this factor is given substantial weight. The Delaware courts view ratification as shifting the burden of proof to the objector to show that the transaction is unfair. In the litigated mutual fund cases, where shareholder ratification typically is involved, this burden is to "convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given." Even if "waste" of corporate assets is alleged, judicial security is limited, for "if * * * ordinary businessmen might differ on the sufficiency of the terms" of the contract, fee, etc., "then the court *must* validate the transaction." *Saxe* v. *Brady*, 40 Del. Ch. 474, 486, 184 A. 2d 606, 616 (Ch. 1962). Although not an impossible burden, it is manifestly a heavy one. Most importantly, it will almost invariably be the applicable standard since overwhelming shareholder ratification of contracts with investment advisors may be had for the asking.

Under state law standards, probably persons of "ordinary, sound business judgment" will not deem the compensation unreasonable so long as the fee is not too far from the classic level (½ of 1% of average net assets with some scale-down at high levels) long prevailing in the industry for externally managed funds. Even if this standard were a satisfactory one in theory, *Saxe* v. *Brady* demonstrated the difficulty of applying it to a concrete situation because of the unavailability of comparative data to measure the reasonableness of the fee paid by a particular fund. For instance, absent such information, a court cannot rationally assess the quality of services furnished by the advisory organization, or its level of profits, or the reasonableness of expenses incurred. Finally, several able judges have visibly winced at the restrictions of this rule which has required them to sustain fee schedules which seemed to them excessive, but not so much so as to point to fraud or over-reaching, or otherwise to a violation of the applicable standards. See *Saxe* v. *Brady*, 40 Del. Ch. 474, 497–98, 184 A. 2d 602, 616–17 (Ch. 1962); *Acampora* v. *Birkland*, 220 F. Supp. 527 (D. Colo. 1963). It is clear, then, that the prevailing state-law judicial tests are inadequate to deal with the problem of excessive fee levels. And the fact that they are excessive is indicated by the number of cases which were settled with advisory fee reductions. To put the matter into context, it must be remembered that this entire fee is borne pro rata by the shareholders of the fund since the amount, whatever it may be, is skimmed off the gross revenue of the fund before distributions are made.

(b) *State Statutes.*—A development not noted by the SEC Report but important for the future is the advent of statutes specifically validating transactions, otherwise doubtful or involving conflict of interests. Several states, most importantly Delaware, have statutes which uphold transactions between a corporation and a director or officer, or between interlocked corporations, if full disclosure is made to the director and the transaction is approved by a majority of the disinterested directors "in good faith"; or if the shareholders ratify the transaction after full disclosure; or, in any event, if the transaction is fair to the corporation as of the time it is made. Delaware Gen. Corp. Law § 144(a).[2] If any one of these conditions is met, the transaction is substantially immunized from attack.

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[2] The reference is to the newly enacted Delaware General Corporation Law, signed by the Governor on July 3, 1967.

I believe that these statutes would make it even more difficult for mutual fund shareholders to challenge advisory fees than has been true under the judicial doctrines. Thus, full disclosure to all directors in the case of an investment company—will end the matter if the directors act in "good faith" which ordinarily they could show, for "good faith" is a less rigorous standard than "fairness." In all events, ratification by the shareholders after disclosure—which, of course, the Investment Company Act authorizes—would be conclusive even if director approval were not. Accordingly, these statutory standards would not ease the objector's burden, and probably they would increase the effort necessary to win a judgment for the fund or affect a satisfactory settlement.

(c) Finally, I point out a new and somewhat unnoticed development occurring in the state law of fiduciary duty which, ultimately, is involved in any determination of reasonable management compensation. This is the tendency of some courts to apply to situations, involving definite although subtle interest conflicts, the famous "business judgment" test. This concept originally meant that if the directors of a corporation, acting without any conflict of interests or otherwise in breach of duty, approved a transaction, it is immune from attack even if it proves to be wrong, even disastrous to the corporation. Originally, it was not applied when directors did have an interest conflict; there the orthodox rule required full "judicial scrutiny" of the transaction to discover and extirpate any taint of wrongdoing. Several relatively recent decisions in corporation law are susceptible to the interpretation that the business judgment rule has been applied beyond its original contours to uphold a transaction in which interest conflicts inhered. *Warshaw* v. *Calhoun*, 221 A.2d 487 (Del. Sup. Ct. 1966); *Case* v. *New York Central R.R.*, 15 N.Y.2d 607, 256 N.Y.S.2d 607 (1965), cf. *Cheff* v. *Mathes*, 199A.2d 548 (Del. S. Ct. 1964). Although these decisions deal with problems altogether outside the mutual fund field, I believe that they point a warning signal for Congress to consider in determining whether legislation on mutual fund fees is necessary. Should this line of decisions grow, I believe that it would be an easy step for a court to rule that the compensation level for an advisory organization lies within the business judgment of the directors, or at least those not affiliated with the advisor-underwriter. *Saxe* v. *Brady's* language, already quoted, is indeed a bridge to that result since it frames the test in terms of whether "ordinary businessmen" would differ on the sufficiency of the terms. I say this even though taking full account of *Saxe* v. *Brady's* significant warning that "the business community might reasonably expect that at some point" the management fee would be adjusted downward to "reflect the diminution in the cost factor." 40 Del. Ch. 474, 498, 184 A.2d 602, 616–617 (Del. Ch. 1961).

3. The reasonableness standard of the bill

Despite some attack upon the supposed vagueness of the "reasonableness" standard, the test is as precise as it is possible in an area requiring fact determinations in particular cases. Indeed, the test of management compensation in state corporate law is one of "reasonableness", with additional content derived from the subsidiary standards applied in the mutual fund cases and by manipulating the burden of proof depending upon ratification. Thus, the general standard is the only conceivable one which could do justice to all situations covered by it.

In my judgment, the bill appropriately identifies the components of the "reasonableness" standard without limiting the factors to be considered by the courts. The four designated factors are the ones which judicial decisions and informed discussion have viewed as significant. Flexibility is guaranteed by subsection (d)(2)(E) referring to "such other factors as are appropriate and material."

4. Burden of proof

My chief doubt about the provision lies in its placing the burden of proving unreasonableness on the party objecting to the fee level. Even when reasonableness is the criterion, it will be difficult for the outsider to secure the data which will enable him to establish the unreasonableness of compensation, especially in light of the factors comprising reasonableness under the statutes. Most of these factors relate to internal matters, information on which is not likely to be available to the objector. For instance, it will require considerable effort to obtain, if the effort is successful, facts bearing on the quality of services rendered to the fund or to the advisor's other clients ((d)(2)(B)), economies of scale within a complex of funds managed by a single advisor ((d)(2)(C)),

and the value of all benefits received by the advisor by reason of his relation to the fund ((d)(2)(D)). Much of this information is in the possession of the investment advisor, a separate corporate entity, to whose books and records a mutual fund shareholder's inspection rights do not extend under state law, although liberal discovery may somewhat ease the task.

I conclude that the bill should place the burden of proving reasonableness upon the defendants because they are in the best position to produce relevant data—far more so than the outsider seeking to obtain records and information of which he necessarily has only vague knowledge. Indeed, state corporate law has often recognized that a fiduciary is in a better posture to prove the reasonableness or fairness of his action than the challenger is to establish the contrary. Unless the burden is imposed on the defendants, I believe that the proposed law may effect only a paper change—from the restrictive state law standards currently applicable, to a theoretically generous federal standard impaired in practical effect by its pendant burden-of-proof rule.

An additional reason for placing the burden of proof on the advisor-underwriter, and affiliated persons is that they are properly viewed as fiduciaries for the fund and for its shareholders. Although some sharply contest this view, contending that the advisor bargains at arms length with the fund whose interests are protected by the unaffiliated directors, the fact is that even state law now tends to view a person or entity in control of another as having at least some responsibilities of a fiduciary character. Instances include a controlling shareholder who may or may not also be a director or officer of a corporation. But the principle is not necessarily limited to one whose control is achieved through means other than shareholdings. Thus, in the mutual fund fee cases control is exercised through the affiliated directors, coupled with the facts that the advisor is usually the fund's founder and that the contract between advisor and fund is for practical purposes not terminable either by the unaffiliated directors, the fund shareholders, or by someone seeking to stage a proxy fight and substitute another advisor.

Accordingly, I believe that the bill should place the burden of proving reasonableness on the defendants. If so, it should also make clear that this burden remains there even though the contract is approved by a majority of unaffiliated directors or by vote of the shareholders. If this is thought to be too strong, I would suggest the following alternatives: (1) The burden of proof should never shift as a result of shareholder ratification, but (2) the burden of proof could shift to the objector if, but only if, the contract is specifically approved by a majority of directors, none of whom is an "interested person" within the meaning of that term as it would be defined in proposed Section 2(a)(19) (see Section 2(3) of the Investment Company Amendments Act of 1967). As indicated later,[3] I believe that this definition should be enacted, for it is essential for protecting fund shareholders from serious conflicts of interest, not touched by existing law, that the statutory provisions go beyond the somewhat narrowly defined "affiliated person" (Section 2(a)(3) and embrace others whose interests may be at least as adverse to the fund and its shareholders as "affiliated persons." Thus, if the contract has the approval of a majority of genuinely disinterested directors—whether or not affiliated under the existing definition—it would seem appropriate to permit the burden of proof to shift to the objector.

I reiterate my main contention that any enactment should impose on the defendants the burden of proving reasonable compensation (subject to possible modifications as noted above), rather than, as in the proposed bill, requiring the objectors to demonstrate unreasonableness by a preponderance of the evidence.

II. FIDUCIARY DUTIES AND THEIR ENFORCEMENT

The Investment Company Amendment of 1967 would more effectively enforce the fiduciary duties of fund directors, advisors, underwriters, and others in position of control or significant influence. I comment on several which I think are essential.

1. Definition of "interested person"

Section 2(3) of the bill would add Section 2(a)(19) to the 1940 Act defining a new term "interested person" which would then be employed elsewhere in the Act, notably in Section 10 (relating to permitted and prohibited affiliations of

[3] *Infra*, pp. 804–806.

fund directors), Section 15 (required approval of advisor-underwriter contracts), and Section 32(a) (relating to approval of financial statements by independent accountants).

One of the often used key terms of the 1940 Act is "affiliated person." For instance, Section 10 imposes percentage limitations on the number of directors who may be "affiliated persons", of the investment advisor or underwriter, while under Section 15(c) investment advisory contracts must be approved by a majority of directors who are not parties to the contract or "affiliated persons" of a party, unless the fund shareholders ratify the contract. Section 2(a)(3) defines "affiliated person" to include one who owns or controls more than 5% of the voting stock of another, one who is an officer, director, or partner or employee of the other person, or one who is "directly or indirectly controlling, controlled by, or under common control with" the other person. Under Section 2(a)(9) ownership of 25% of the voting securities of a company raises a presumption of control. The "control" definition is unfortunately limited by raising another presumption that "a natural person shall be presumed not to be a controlled person."

This cluster of terms, although seemingly inclusive, is in fact inadequate and inhibiting. Certain loopholes permit relationships, strongly savoring of serious interest conflicts, to flourish uncorrected. For instance, a director is not an "affiliated person" even though he owns 4.99% of the stock of the investment advisor. Thus, his vote on the advisory contract counts as one of the all-important unaffiliated director votes, although certainly he is hardly disinterested. Again, the son of the controlled share holder of the principal underwriter or advisor is not an "affiliated person," although he too is scarcely a disinterested director when voting on the contract between the fund and his father's firm. Even if it could be argued that such persons are "controlled" by the advisor or underwriter, this contention is defeated since the fact of "control", under existing law (Section 2(a)(9)), must be affirmatively proven because a natural person is presumed not to be "controlled." As a final instance, the attorney on retainer of the advisor or underwriter is not an "affiliated person" under present law; establishing that he is a "controlled" person encounters the difficulties just noted.

Since the critical term in the existing law—"affiliated persons"—does not come close to covering all persons who have a significant economic or other interest in a fund's advisor-underwriter, it is clear that decisions which must be made by unaffiliated directors are being made by interested directors. Indeed, since the advisor normally is in a position to secure the election of all the directors of the fund, it would be fatuous to suppose that one holding such control will knowingly place on the fund's board persons who will be other than kindly disposed to the advisor's interests. This is not to suggest that unaffiliated directors breach their duty. It is to declare emphatically that many such unaffiliated directors are in a posture of unavoidable conflict of interests, even though they do their best to resolve those conflicts as decent and honorable men. But the very existence of such conflicts deflects the main thrust of the Act: that a certain percentage of directors will be the disinterested, dispassionate protectors of the interests of the fund shareholders especially when the critical question of the advisory contract is to be voted upon. One need not suppose that an unaffiliated director is necessarily subservient to the advisor. However, his delicate position of subtle dependence will dispose him to resolve doubts in favor of the advisor, to stress in his own mind the quality of services actually rendered rather than investigate the possibilities of improvement, to silence nagging doubts that the compensation formula may be producing excessive compensation as fund assets grow, to soften the probing question or forego the extra hours of independent inquiry into comparative statistics and information, or to ignore suspicions as to the propriety of sales practices under the fund underwriter's auspices. Congress in 1940 no doubt believed that unaffiliated directors would pursue such efforts on behalf of the fund and doubtlessly in some measure these expectations have been fulfilled. But the fact of mere partial fulfillment is disquieting, and the failure has occurred in crucial areas of fund operation. For example, almost none of the externally managed funds took steps to reduce compensation under the classic one-half of 1% of net assets formula, until pressure was generated by the Wharton School Report and, more tangibly, the numerous shareholder derivative suits challenging operation of the formula.

It could reasonably be supposed that truly disinterested fund directors would have anticipated the undue swelling of compensation under a rigid formula and

would have urged reduction of compensation so that the advisor would pass on to the fund shareholders some of the economies of sale. As Chancellor Seitz stated in *Saxe* v. *Brady*, 40 Del. Ch. 474, 497–98, 184 A. 2d 602, 616–17 (Del. Ch. 1962), "t is not to be assumed that an independent board would wait until the fees paid under the management contract warranted a finding of waste before attempting to negotiate a better deal," for "ideally a truly independent and active board would be expected to be alert to the factors" bearing on the reasonableness of compensation. In this case, Chancellor Seitz assumed without deciding that "an independent board was not present" despite the requisite number of unaffiliated directors.

The bill's provisions would go far towards correcting these deficiencies in the original act. Section 10(a) would be revised so that no more than 60% of the board will be "interested persons." This substantially enlarges the corresponding prohibition in original 10(a) which barred a like percentage of persons who are investment advisors or "affiliated persons" of the adviser. The enlargement derives from the much broadened definition of "interested person" in Section 2(a)(19). Similarly, the prohibitions of Section 10(b) are reframed in terms of "interested" persons rather than "affiliated" persons as in the original act.

Most significant is the effect on Section 15(c) which presently requires approval of the advisory contract by "a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party" (unless ratified by the shareholders). The new provision would require approval by a majority who are neither parties to the contract nor "interested persons of any such party." It would add three additonal safeguards.

First, ratification by shareholders is deleted—quite properly, I believe, because it has been a convenient northwest passage around the existing statutory requirement of approval by a majority of non-affiliated directors. Indeed, ratification even with full disclosure, is hardly any safeguard at all, because it can be so easily obtained from shareholders who have little interest in what they are being asked to vote on if, indeed, they understand what they are doing let alone its legal significance.

Secondly, the directors must vote on the advisory contract "in person at a meeting called for the purpose of voting on such approval." This insures that each disinterested director will have specific notice of the purpose of the meeting. Presence at the meeting at least insures a forum for a free exchange of views and ideas, whether or not it does in fact occur.

Thirdly, all directors would have a specific duty in this context: to "request and evaluate" information "reasonably necessary to determine the reasonableness of compensation." The advisor has a correlative statutory duty to provide such information. The first part of this provision probably only declares existing law, for directors always have a duty, when voting on compensation, to consider its reasonableness. However, the statutory declaration should bring home this duty much more sharply to all directors and stand as a continuing reminder when the common-law duty may be forgotten. After all, most corporate directors are not lawyers; a specific statutory statement is apt to be quite meaningful to them.

The definition in Section 2(a)(19) of "interested person" is more inclusive than the older term "affiliated person."

(A) It includes any "member of the immediate family" of a natural person who is himself an "affiliated person." This would cover the example, *supra*, p. 805, of the son of the founder and chief stockholder of the advisor, who under present law may be an "unaffiliated" director. (Incidentally, "member of the immediate family" is itself specifically defined at the end of Section 2(a)(9).)

(B) It includes anyone who has a direct or indirect beneficial interest in securities issued by the advisor or others as well as certain fiduciaries (such as trustee, executor or guardian) who hold such beneficial interests.

(C) It includes any person who currently or within the past three years, has "any direct or indirect material business or professional relationship" with the advisor or others. This would cover the situation described, *supra* p. 805, of the attorney for the advisor who may at present sit as an unaffiliated director of the fund.

(D) The definition makes clear that it extends to "interested persons" of an investment advisor, principal underwriter, regular broker, or investment banker and any controlling persons of such entities.

2. Enforcement of breaches of duty

Section 36 of the 1940 Act authorizes the SEC to proceed against certain persons for "gross misconduct or gross abuse of trust" towards an investment company. This provision has been ineffective. For one thing, the very terms themselves exclude most situations involving ordinary breaches of duty or conflict of interests. The adjective "gross" connotes something much more serious, perhaps bordering on the criminal. Secondly, when the SEC has used this provision to challenge certain types of duty breach, it has been unsuccessful precisely because the activity complained of lacked the degree of turpitude suggested by the language of Section 36. See *SEC* v. *Insurance Securities, Inc.*, 254 R.2d 642 (9th Cir. 1958). Compare *Aldred Inv. Trust* v. *SEC*, 151 F.2d 254 (1st Cir. 1945). Finally, the SEC has been reluctant to use this section to stigmatize conduct, which may well be questionable, with the pejorative terms "gross misconduct or gross abuse of trust," apart from the fact that the conduct may not itself be so "gross" as all that.

Because the present Act lacks any general provision for the SEC to challenge breaches of duty—and, indeed, the very presence of Section 36 may be interpreted adversely to implying other and wider enforcement powers in the statute—most of the important litigation has been instituted by private parties in state courts. This is most obviously true of the cases attacking the advisory fee; and, as indicated earlier, the courts unfortunately invoked state law restrictions which proved to be inappropriate to the difficult and subtle problems in the litigation, although outstanding judges, such as Chancellor Seitz in Delaware, recognized the anomaly.

Quite clearly, the statute should give the SEC standing to invoke court aid in situations not now encompassed by the narrow terms "gross misconduct or gross abuse of trust." Section 20 of the Investment Company amendments would permit an action if certain persons have or will engage "in any act or practice constituting a breach of fiduciary duty" to the fund. This includes the offenses covered by existing language, but the merit of the proposed revision is that it will permit challenge of many other types of duty breach or interest conflicts. Both in the existing law and under the proposed language, the same persons will be covered: officers, directors, investment advisors, depositors, and principal underwriters.

3. SEC intervention in certain private actions under the Investment Company Act of 1940

Section 23 of the Investment Company Amendments of 1967 would amend Section 44 of the 1940 Act by adding new provisions authorizing the SEC to intervene as a party in any action growing out of two of the major new substantive provisions which have been proposed. The first would permit SEC participation in any action seeking to enforce the standard of reasonableness (new Section 15(d)) which would govern the compensation charged to a fund by its investment advisor or principal underwriter. See discussion of this substantive provision, *supra* at pages 801–804. The second would authorize SEC intervention in private actions enforcing the prohibition in new Section 15(g) against certain transfers of the assets or securities of an investment advisor in the change of control occasioned by such transfers would "likely * * * impose additional burdens on the investment company or limit its freedom of future action or otherwise is inequitable to such investment company."

I believe that it would be desirable to authorize SEC participation in both classes of suits when instituted by private parties. Both proposals involved new, and in some respect novel, statutory provisions. I believe that SEC expertise on these topics would be of material aid to courts in developing a sound body of case law, since the SEC could thus bring to bear its accumulation of data and information demonstrating the need for enactment of these substantive provisions. Intervention is particularly needed in management fee cases if, as the bill provides, the burden of proving the unreasonableness of a particular fee rests throughout the case on the plaintiff.[4] Since this is a heavy burden to be carried by a private party, the balance in favor of the fund and its advisor-underwriters, would be slightly redressed if the objector has the material support of the SEC. Accordingly, I favor enactment of the changes in Section 44 of the 1940 Act (as provided for in Section 23 of the Amendments).

[4] I have indicated earlier my view that the burden should rest upon the defendants to prove the reasonableness of the fee. See pp. 803–804.

III. CONTRACTUAL PLANS (FRONT-END LOAD ARRANGEMENTS)

(Section 16 of the Investment Company Amendments of 1967, amending Section 27(a) of the Investment Company Act of 1940)

The SEC proposes an amendment which would make unlawful the front-end load feature of certain contractual plans for buying mutual fund shares. Needless to say, this does not interfere with the established and sound practice of purchasing mutual fund shares over a more or less lengthy "contract" period, so long as the sales load is distributed evenly over all payments. This proposal is less radical than it appears at first blush since it does not interfere with sales on a "level-load" basis, and since the existing Act already partly regulates front-end load plans by forbidding deduction of more than 50% of the aggregate payments for the first year. However, this proposal has met heavy resistance from the industry because it would abolish a rather strong incentive to sell funds and collect an unusually large commission at the outset. I concur with the proposal to amend the Act to eliminate the front-end load feature.

1. I believe that an overwhelming case has been made out, both by the Wharton School Report and the SEC Study, for this proposal. Evidence shows the extent to which many mutual funds purchasers fail to complete their payments, and that most defaults occur within two or three years of initiating the contract, so that a disproportionate amount of money paid by the purchaser never is invested for him. Even if a contract plan is carried to completion, mathematically it is impossible for the investor to have working for him (on a front-end load plan) the same amount which would have been working for him over the same time period (on a level-load plan). See the statistics in the SEC Study at page 235. Full disclosure of all facts pertinent to the front-end load plan does not afford adequate protection because of (1) the difficulty of many investors in understanding the plan, (2) their failure to realize, when contemplating a default on payments, the consequences of the default; and (3) the fact that salesmen have such a strong economic incentive to push front-end load plans that they are unlikely to indicate the advantages of a level-load plan. Since the Investment Company Act, unlike the Securities Act of 1933, does not predicate its regulation solely upon a disclosure philosophy but has incorporated substantive safeguards, I believe it would be consistent with the Act's premises to extend this needed protection to unwary investors. More particularly, I believe that the front-end load plan imposes upon such investors a heavy and substantial risk of loss on top of all normal investment risks; and that since this is most likely to happen to investors least able to bear the risk of loss, it should be outlawed.

2. I address myself to several misconceptions promoted by industry sources concerning front-end load funds:

(A) The front-end load plan is chiefly defended on the ground that it encourages systematic savings. Assuming this to be so, the effectiveness of the supposed deterrent would depend upon the investor's knowledge of the consequences of default—and, more particularly, on his knowledge of these consequences at the time he must decide whether to default or not. The Wharton Study indicated widespread ignorance of the mechanics of the front-end load plan, and to that extent the deterrence is unlikely to operate. Such deterrence as there is necessarily less pointed and dramatic than the loss of a house, consumer goods, or insurance upon non-payment of an instalment. One is less affected by knowing—if he does know—that he has a small investment relative to the amount actually paid in. Thus the argument for stimulus to systematic savings is, at best, a weak one, and the losses are out of proportion to what little may be achieved in the way of prompting savings. If this is genuinely a concern of the industry, it would seem that fairer means could be devised.

(B) Even if an investor consciously elects to default on payments and bear the adverse effects, I do not believe that it is fair and equitable to exact what is in effect a penalty, especially since the default may be prompted by economic or personal troubles or needs. To state it otherwise, such consequence is at variance with the general philosophy of the federal securities act of protecting investors, and inconsistent with one object of mutual funds in affording a better investment medium than securities selected haphazardly or ignorantly. The fact that some investors may later resume payments and get their status restored does not justify the loss to others who cannot or do not wish to resume payments. Also the fact that the investment actually made, if retained with the fund, may catch up with the heavy initial load is equally inapposite; apart from the fact that the

asset value may not increase, the purpose of all investment is, after all, to enable the investor to secure capital appreciation and income. Thus, no investor should be expected to pay for losses due to heavy commissions on the first year of payment by contributing a portion of his capital appreciation for this purpose. The reasonableness of a commission, or the timing of its payment, should be measured by the amount actually invested, not by the prospects for later performance of the investment; to argue the contrary would justify higher than ordinary commissions on "growth" as against stable "income" stocks.

(C) Some have contended that the front-end load feature for mutual funds does not differ in substance from similar heavy commissions in early years to insurance salesman, or large early year interest payments on a house mortgage or other goods purchased "on time." The critical difference is that both the insured and the home owner have immediate enjoyment of the benefits or goods for which they have contracted. Death benefits for the insured who dies the next day are not scaled down, nor does the home owner receive only a half or some part of his house.[5] In contrast, the purchaser of mutual fund shares under a front-end load plan finds that after one year of payments, his investment is only one half of the total amount paid. Moreover, the insured, besides getting full protection at once, also presumably receives, so long as he holds the policy, various services of his insurance agent, such as aiding him in processing a claim, etc. In contrast, once the front-end load plan has been sold, there is little more for the mutual fund salesman to do; and because the greatest part of the commission has been earned in the first year, he lacks economic incentive to work further with the investor under the plan or encourage his continuance. In short, the front-end load plan is essentially, and probably solely, a salesman's incentive to induce someone to initiate, but not necessarily to complete, the plan agreed upon.

3. Assuming that the prime reason for the front-end load plan is to quickly augment salesmen's commissions, it would be difficult to argue that this incentive is needed to promote the legitimate and desirable growth of the industry. Four major states—California, Illinois, Ohio, and Wisconsin—either prohibit or substantially regulate front-end load plans; and in California, which bars such plans, more mutual fund shares are sold than in any other state.[6] This indicates that whatever incentive is afforded to salesmen, it is one which can and should be dropped, without serious detriment to the industry.

IV. SALES LOADS

(Section 12 of the Investment Company Amendments of 1967, amending Section 22 of the Investment Company Act of 1940)

The SEC has proposed key amendments to the 1940 Act restricting the sales load on mutual fund shares to a maximum of 5% of the amount actually invested in the fund. Because this is the most controversial provision of the bill and would, apparently, have widespread impact in the idnustry, I comment in detail on this provision, and particularly on the objections made to this proposal. I state at the outset that I endorse this proposal subject to the SEC's discretionary power to grant exemptions in appropriate situations.

1. The typical sales load of 8.5% measured as a percentage of the total amount paid by the customer (or approximately 9.3% of the amount actually invested in the fund) seems needlessly high. This 9.3% figure is roughly four and one-half times greater than the total commissions charged for a "round trip" (purchase and sales) of shares listed on the New York Stock Exchange.[7] It contrasts unfavorably with the aggregate charges for purchase and sale of securities traded over-the-counter, on the basis of statistics from industry sources summarized in the SEC Study at page 212.[8] Perhaps most markedly, it con-

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[5] The analogy with house purchases is also misleading, since the fact that a large proportion of early-year payments goes to interest simply reflects the fact that the loan is larger in early than in later years.

[6] See Investment Company News, Vol. 7, No. 4 (April–May 1967), p. 3, for statistics on sales by states. 1966 California sales amounted to $1,042,005,000, with New York second with sales of $564,001,000.

[7] This is nine times greater than the commission for a purchase alone. However, I agree that comparisons are properly made between the mutual fund sales charge (9.3%) and total commissions for a "round trip" since mutual funds redeem their shares without any charge or a miniscule charge at most.

[8] "SEC Study" refers to *Report of the SEC on Public Policy Implications of Investment Company Growth (1966)*, H. Rept. No. 2337.

trasts with the existence of (1) no-load funds which, while relatively small in relation to the load funds, are nonetheless substantial investment companies, and with (2) the closed-end funds on which sales charges are normal stock exchange commissions. Like stock exchange commissions, the much higher mutual fund sales load is not subject to competitive forces working in favor of the customer seeking a lower commission; but it stands at a rigid and fixed level protected against downward competitive pressures by the resale price maintenance provisions of the Investment Company Act.[9] The sales load itself is also supplemented indirectly by the mutual funds, either in the form of give-ups to brokers vigorously promoting sales of a fund's shares, or indirectly by the fact that the fund itself prepares much of the sales literature.

I believe that, in view of these factors, the mutual fund load is excessive. This is, I submit, especially true in light of the great (and, on the whole, deserved) increase in the size of the funds since 1940, whose economies of scale should operate both to reduce the sales load and the investment advisory fee.

2. *Objections to the Proposed 5% Maximum.*—Before considering the specific industry objections, I stress that the 5% figure is not a rigid ceiling. The bill would specifically empower the SEC, by rule or order, to exempt persons, securities or transactions from the 5% figure. The relevant and familiar standard is whether the requested exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes" of the Act. Where the SEC has administered the Act in other areas, it has employed its exemptive powers in a fair and just manner so as to achieve the test's objectives of serving the public interests and protecting investors. Accordingly, the exemptive power given here should carry persuasive weight in establishing a fixed ceiling.

(a) It is suggested that 5% is an arbitrary, indeed capricious, figure without foundation in economic studies. It is apparently true that the SEC Study has not reported specific economic data for choosing 5% rather than some lower or higher figure. It would seem, however, entirely fair to adopt a percentage figure lying roughly halfway between the aggregate 2% commission for stock exchange commissions and the existing 9.3% sales charge (8.5% load). It seems no more objectionable than the NASD's declaration of a 5% ceiling (subject to exceptions) for charges on transactions in over-the-counter stocks. For reasons later indicated, I doubt that a comprehensive study of all economic factors and impacts would enable the Congress to come up with a more exact percentage figure, in view of the many variables. Coupled with the exemptive power, the 5% figure seems appropriate. Its fairness is indicated by the fact that many funds have been able to exist and serve their shareholders without exacting any sales load at all.

(b) It has been suggested that the SEC would enter the area of ratemaking for the first time by having power to administer a 5% ceiling, and that this converts the investment company industry into a public utility. The fact is that Congress in 1940 decided to treat investment companies as a type of public utility when it established the comprehensive regulation of the 1940 Act. Although "rate making" did not figure prominently, Section 27(a) of the 1940 Act did indeed confine sales loads to a 9% maximum and also limited initial sales loads in connection with front-end load (contractual) plans. The issue is not whether investment companies shall become public utilities—for they are that already—but whether a certain type of regulation of sales charges is appropriate.

(c) It is contended in industry sources that cutting the sales load to 5% from existing levels will drastically reduce the profitability of many broker-dealers, especially small firms. I put to one side the tendency of virtually any industry confronted with possible regulation to claim that irreparable economic injury will result, and especially the disposition to play upon sympathies for "small business". Turning to the merits, the chief contentions are based upon a study by Booz-Allen Applied Research, Inc., for NASD, indicating that a large number of firms would have fallen into a net loss position if the 5% figure had been in effect during 1966. I believe that this type of speculative conclusion should not carry the weight which the industry would urge:

(A) The study evidently assumed that there would be no changes at all in methods of operation, number of personnel, etc.; but merely applied the 5%

[9] Investment Company Act of 1940, § 22(d).

figure to existing operations. But surely if lower aggregate revenues are reasonably to be anticipated, prudent firms would seek to enhance the efficiency of their procedures. The study does not consider, for example, whether an excessive number of persons are engaged in heavy selling of mutual funds. or whether sales efforts are scattered over marginal prospects.

(B) The study also assumes that the level of commissions for other types of securities business will remain unchanged. In fact, the commission rate structure, at least for New York Stock Exchange transactions, may well be altered upward. In all events, one cannot assume for the indefinite future that the commissions for each type of securities business will continue at present levels.

(C) Assuming *arguendo* that some firms will suffer from a lowered rate, the real question is whether mutual fund purchasers should be called upon to underwrite inefficient firms, excessive sales efforts, or unduly low commissions (if such is the case) on other forms of business. I find it difficult to believe that the typically small investor who buys mutual funds should have to furnish a subsidy of this sort.

(D) The 1940 Act, by its somewhat limited regulation of mutual fund sales charges, necessarily impaired the profit-making potential of some firms selling mutual fund shares. Evidence presented at the time to the Senate showed that sales loads had ranged as high as 20%, and that front-end load charges for the first year had exceeded the 50% figure allowed by the 1940 Act. Thus, Congress has already exhibited willingness to balance the interests of investors in mutual funds against the interest of sales organizations in securing as high a level of charges as possible, and to extend protection of investors even at some cost to the profit-making potential of the sellers.

(d) It has been suggested that since load funds to give a quantity discount (unlike stock exchange commissions), this accords the fund investor a "break" not available to purchasers of exchange-listed shares. This contention is hardly relevant, since the "breakpoint" for a reduced sales load comes only at high purchase levels, even when it is available for a contract with purchases spaced out over a period of years. Thus, the SEC Report indicates that the first breakpoint for many funds occurs at an investment of $12,500 (when the load drops from 8.5% to 7.5%).[10] Since most mutual fund purchasers are small investors, it is doubtful that many receive the benefit of even this relatively small reduction in sales load. In all events, prime consideration should be given to aiding the small investor in seeing that a greater proportion of his funds actually go to work for him with the fund rather than into a sales commission which produces nothing for him.

(e) It is suggested that no comparison with a stock exchange commission is valid because the mutual fund purchaser acquires, not a security in the usual sense of the word, but a type of "service". Sometimes, comparisons, highly favorable to the mutual fund, are made to show how large an aggregate commission the investor would have to pay if he were to attempt to duplicate this "service" by buying a small number of shares of many stocks. Granting that the purchaser does indeed receive a significant "service" through a mutual fund, the conclusion—that sales loads should not be disturbed—does not follow. First, the mutual fund purchaser pays each year for that "service" through the fund expenses deducted from the fund's gross income for advisory or administrative fees, annual reports, prospectuses, and so forth. Thus, he pays an annual fee for this service. The sales load does not compensate for any service performed by the fund; its function is simply to provide a profit—the amount of which is, of course, disputed—for the sales organization. This is demonstrated by the fact that closed-end companies and no-load funds similarly provide an investment "service" paid for through deductions from the fund's gross income. The argument from the fund's "service" functions, as applied to sales loads, is so far off base as to be, in my judgment, misleading.

3. *Alternative 1: Repealing Resale Price Maintenance Provision of the 1940 Act.*—A possible alternative is to place no ceiling on sales load but repeal Section 22(d) of the 1940 Act precluding dealers from selling mutual fund shares except at the price determined by the underwriter. This provision has, of course, precluded price competition among funds and their salesmen to attract customers by giving price reductions out of the commission. Indeed, it has generated a different sort of competition with an upward thrust to prices, for it induces funds

[10] SEC Report at p. 210.

to raise sales loads in order to stimulate brokers to maximize their efforts to sell the fund's shares.

Although I quite frankly do not like legally authorized resale price maintenance by any industry—and I speak on this from my own experience as a former attorney in the Department of Justice's Antitrust Division and from teaching antitrust—I am reluctantly led to believe that this alternaive would no be preferable to a ceiling on sales loads. Like it or not, resale price maintenance is a fundamental part of the securities industry, and of the investment company business in particular. Repeal of this provision might have undesirable repercussions not readily determinable at this time. It might prompt defensive measures among investment companies seeking to preserve the status quo and thereby create complex and difficult antitrust problems.

Moreover, repealing Section 22(d) would not apparently affect the price levels charged by some mutual funds selling shares through their own sales organizations (the so-called "captive" sales force) rather than through broker-dealer channels. Even if price resale maintenance were outlawed, this would not preclude such funds from setting the prices at which their own employees could sell the shares. Indeed, there may be some disturbing side-effects. For instance, if such funds could continue to charge comparatively high loads, this would lure salesmen away from broker-dealers into "captive" sales forces; and if loads could be thus stabilized, other funds, currently selling through broker-dealers, might shift to internal sales organizations. Thus, a long-range effect could be diversion of business away from smaller broker-dealers who are said to depend on mutual fund sales, to funds with internal sales organizations. I doubt any major competitive impact of sales-load price-cutting by broker-dealers seeking to keep or attract business away from funds with internal sales organizations. True, a lower sales load offered by a broker-dealer would be a good talking point to a customer. However, it is at least doubtful that mutual fund prospects would do much shopping around, especially to look for lower sales loads; after all, they have not done so in the existing situation where no-load funds can be obtained.

In sum, I doubt that repeal of Section 22(d) standing alone would quickly, and perhaps not at all, bring mutual fund customers the supposed advantages of competition among salesmen. The benefits of repeal seem to me too conjectural to make such a move a predictably effective means of redressing the problems of excessive sales charges.

4. *Alternative 2.*—One variant of the first alternative is to repeal Section 22(d) and require that each fund make its shares available to all broker-dealer members of the NASD at the net asset value of the shares plus a reasonable underwriters' spread. If this became law, broker-dealers could obtain mutual fund shares at "wholesale" prices and then retail them at prices determined by competition among themselves. This does, indeed, have much to commend it. However, it also creates problems. First, it would require repeal of Section 22(d) and resale price maintenance, and to that extent alters established marketing patterns in the industry. Secondly, it would compel substantial changes in methods for those funds utilizing their own internal sales organizations; for they, too, would presumably have to sell "wholesale" to broker-dealers who would (and should) be free to compete with the fund's own salesmen. Thirdly, it would be necessary for some body (presumably the NASD) to determine what is a reasonable spread properly charged by the fund to broker-dealers selling fund shares.

While this alternative seems attractive, I think that its hoped-for benefits may outweigh its difficulties. Besides requiring all funds to give up traditional resale price maintenance, it would compel funds with "captive" sales forces to change their methods of doing business and in effect establish competition with themselves.

On balance, I believe these two alternatives are less attractive than setting a maximum sales load of 5%, which is a remedy addressed to the specific problem of excessive sales charges. In particular, I think that the approach suggested by the SEC is ultimately a more conservative one than alternatives which would precipitate changes in industry structure and established marketing methods.

5. *Alternative 3: NASD Regulation.*—I have some difficulty in determining the feasibility of this alternative, as I know of the proposal only from brief newspaper reports. I understand that the standard would be framed in terms of "reasonableness." Presumably, this would require the NASD to formulate more definite content to such a standard by rule-making. To the extent that the NASD might come forward with a 5% or 6% figure, the result would presumably differ

little from the SEC proposal which is subject to exemptions. To the extent that it is more vaguely worded, it would be less apt to give the investor the advantages hoped for, and it could easily involve the NASD in substantial administrative problems in policing the activities of firms and salesmen in charging "reasonable" sales loads. Also, for these broker-dealers not members of the NASD, presumably the SEC would have to formulate its own rules so that non-NASD members would not have certain advantages in freely fixing sales loads while NASD members remain subject to some type of industry-imposed restraint. I have no doubts that the NASD would act in good faith in formulating a standard and in effectively administering it, but I do not see that it would produce a better result than the proposed 5% ceiling (subject to SEC exemptive power).

6. *Alternative 4: Sliding Scale.*—If it believed that an immediate drop to a 5% maximum sales load would be too great an economic hardship on retailing mutual funds, consideration might be given to a gradual downward adjustment. For instance, the maximum load might be 7% for the first year after effective date, then 6% for one or more years, and then 5%. This would permit gradual enhancement of efficient sales practices to adjust to possibly lower revenues. If adopted in principle, either Congress could specify the sales load levels, or it would vest the SEC with discretion to determine when the several downward steps should be taken. However, I believe that Congress should make these specific determinations as a matter of legislative policy. An analogy is the two-staged application of the Securities Acts Amendments of 1964 to over-the-counter issuers required to register with the SEC under Section 12(g) of the Securities Exchange Act of 1934 (as amended), by which the new rules applied first to issuers with at least 750 shareholders, and then the following year to those with at least 500 shareholders.

STATEMENT OF EDWARD S. HERMAN, ASSOCIATE PROFESSOR OF FINANCE, WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

I. INTRODUCTION

This statement deals only with the regulation of the management fee rate and the sales charge. These two areas are treated here in terms of the basic economic rationale of the SEC legislative proposals, with only a minimum of attention being given to the details of the various proposals.

The basic point of this statement is that strengthened regulation along the lines suggested by the SEC is desirable because competition either has not worked or has worked perversely in the determination of both the management fees and sales charges of mutual funds. Moreover, it would not be easy to make competition work satisfactorily in these areas, even with drastic structural reorganization of the industry. The SEC recommendations must therefore be regarded as a conservative compromise between nothing in an area where the market mechanism has worked badly, and more radical changes of uncertain effect.

II. THE MANAGEMENT FEE RATE

The evidence is clear that management fees charged mutual funds have been substantially higher than those charged other investors of comparably-sized portfolios.[1] In the *Study of Mutual Funds* we tested the standard industry explanations of these high rates, and found that neither their level overall, nor the differentials found within the industry, could be explained in terms of performance, services rendered, or expenses. The industry has also relied heavily on the argument that the individual mutual fund investor would not pay a lower management fee rate if he chose the alternative of private counseling. This may be true, but if advisory expenses per dollar of assets decline with increases in fund asset size (as is the case), and if the fund is paying a substantially higher rate than other clients of similar size, can the fund's directors, who have a fiduciary responsibility to the shareholders, justify a high and inflexible rate on the ground that the shareholders cannot do better elsewhere? This would reflect a peculiar conception of directorial obligations!

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[1] Full documentation may be found in *A Study of Mutual Funds,* H. Rept. No. 2274, 87th Cong., 2d Sess. (1962), pp. 480–95; Edward S. Herman, "Mutual Fund Management Fee Rates," *Journal of Finance,* May 1963, esp. pp. 368–74; and for developments subsequent to the Wharton Report, S.E.C., *Public Policy Implications of Investment Company Growth,* H. Rept. No. 2337, 89th Cong., 2d Sess. (1966), Chapter III.

The most plausible explanation of the high levels and relative inflexibility of mutual fund management fee rates rests on the structural characteristics of the industry and the resultant limitations on the effectiveness of competition. One relevant structural characteristic of the industry is the domination of the typical fund by a separate legal entity, the investment adviser, with whom the fund enters into a management contract. Given the origination of the fund by advisory personnel, and the crucial and active role of the dominant individuals associated with the adviser, the terms of the management contract have not ordinarily been a product of arms-length bargaining. The independent director requirement has not altered the situation in this regard, and there is little reason to believe that a tightening of the now hopelessly inadequate definition of an independent director will solve this problem.

A second important structural aspect of this industry relates to the buyers of fund shares: typically they are not very affluent and they buy only a few thousand dollars worth of shares, which has made for a wide diffusion of fund shares. Furthermore, these small investors are not well informed on investment alternatives, including differences among the funds themselves. These buyer characteristics of the industry have made salesmanship important in the merchandising of fund shares; and this, in turn, has led to a de-emphasis on price in approaches to the buyer. The salesman could hardly stress differences in management fee rates (under 1%) without raising questions about differences in the much higher sales charge (8% or more). He therefore prefers to stress fund performance over the last 20 years, the virtues of equity investment and diversification, and the redemption privilege.

The net result of the absence of arms-length bargaining in fixing fee rates, the wide diffusion of fund shares among relatively uninformed buyers, the de-emphasis of price by fund salesmen, and the possibility of redemption if dissatisfied, is that little pressure exists either within funds or between them to reduce management fee rates. The downward pressure on fee rates within the past decade seems to have been a result mainly of stockholder suits and publicity generated from outside the industry.

I would like to note here that the buyer characteristics of the mutual fund market, and the importance of personal selling, make overall numbers of funds and national concentration ratios, very misleading in assessing the degree of competition in the industry. Every serious study of concentration—including those by Kaysen and Turner, and by Bain—stress the importance of the market definition in giving meaning to a concentration ratio. And the market must be defined in terms of both seller and buyer alternatives. If 10 different encyclopedias are being sold door-to-door, if a salesman for one of them knocks at somebody's door, the quality and price of 10 different encyclopedias are not likely to be at issue. If the seller of fund X approaches a householder, there may be only one fund that is offered as a plausible option. The fact that there are 350 funds in existence is likely to be quite irrelevant to the contracting process involved in personal selling, which often approximates bilateral monopoly with an imbalance in bargaining position.

The main policy alternatives that have been put forward to deal with the management fee are as follows:

(1) Do nothing, on the grounds that the problem is not serious, or that market adjustments will correct any abuses in the long run. I would reject this view because, while the problem is not of the first order of importance, it does not strike me as trivial (with management fees now approximately $150 million a year); and there is little evidence that in this area the market mechanism will operate more effectively in the future than it has up to now.

(2) Reorganize the industry's structure by requiring each fund to be internally managed. Since internally managed funds have a simpler structure and tend to have lower fee rates, this would probably accomplish something; but it is not clear how much would be achieved, given the fact that structural conditions would still be unfavorable to competition on the management fee. Since this would be a drastic action, especially in view of the widespread public sale of the stock of outside advisory companies, I doubt if this change would be worth the resultant disruption.

(3) A third possibility woulld be the redefinition of an "independent director", or the use of other devices, to make some of all of the directors truly "independent" and capable of bargaining effectively with the external management firm. The SEC proposes a change in the definition of the independent director,