Address by

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Before the

AMERICAN SOCIETY OF BUSINESS WRITERS

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I am pleased to be able to tell you that a bill has been introduced in the Congress this morning which would carry out the recommendations made by the Securities and Exchange Commission in its Report on the Public Policy Implications of Investment Company Growth.

In his Consumer Message of February 16, 1967, the President urged the Congress to give careful consideration to the Report and recommendations of the Commission. He pointed to the serious questions raised by the Report and concluded that the Commission's recommendations provided a sound basis for measures that will be beneficial to the investing public, and to the health and stability of the industry itself.

When the Commission submitted its Report to the Congress last December 2, 1966, the Commission solicited the comments, suggestions and views of the investment company industry, other elements of the securities industry, investors and other interested persons. Since then we have received numerous letters and we have talked to many persons about the Report and our recommendations. We have also carefully read the thoughtful articles which many of you have written. We have weighed carefully the comments, and the criticisms, we received. In light of them, we believe that the specific legislative proposals that have today been placed before the Congress are well designed to provide additional and needed safeguards for this nation's more than three and one-half million mutual fund investors. These legislative proposals follow very closely the recommendations in the Report. We are sure that the Congress will give them the careful consideration which their importance deserves.

The problems involved are real ones and the interests of millions of American investors at stake.

The most important recommendations in the report and our legislative proposals relate to three matters: First, our bill would expressly require that the management fees charged to investment companies by investment advisers serving them pursuant to contracts be reasonable. This standard would be enforced in the courts either by the company, its shareholders or the Commission.

As our report pointed out, the cost of management of an investment company does not increase in proportion to the growth of a fund. The amendment is designed to assure that the available economies of scale are equitably shared with investment company shareholders in light of the nature and quality of service which the company receives and certain other factors. To provide a reasonable opportunity to evaluate present advisory contracts, the amendment would not become effective until one year after the legislation is adopted.

Second, the bill would repeal the provisions of Section 27 of the Act which permits the deduction of one-half of the investors' first year's payments as sales charges for the purchase of periodic payment plans for the accumulation of mutual fund shares. There are two principal reasons for prohibiting for the future the so-called front-end load. Experience shows that a substantial number of investors are unable or unwilling

to complete their scheduled payments. As a consequence, they incur very large effective sales charges on the amounts they actually invest. We found, for example, that up to one out of five of the investors in various contractual plans completed only one year's payment or less and therefore incurred an effective sales load of 50 percent. Charges of this magnitude subject the small investor to an unacceptable risk of loss on his investment. Even if an investor completes his plan, 50 percent of his first year's payments are never invested and as a result he has less money working for him over the term of his investment. The front-end load is presently prohibited in California, Illinois and Wisconsin. I might point out that, notwithstanding this prohibition, California accounts for more sales of mutual funds than any other state.

Our third major proposal concerns the level of sales loads. In our report we concluded that the maximum sales load on mutual fund shares should not exceed 5% of the net asset value at the time of sale. The proposed bill, however, would permit the Commission to allow a higher sales load where appropriate; for example, in the case of very small transactions.

This recommendation has been the subject of more comment, pro and con, than any of our other recommendations. As you might suspect, public investors generally favor lower sales charges while the firms and salesmen who sell mutual funds are opposed. I do not wish to argue here the merits of this proposal -- that will come during the legislative hearings. But I do want to give you some facts about the securities business and the present regulatory structure which may help you to analyze the problems involved and the possible solutions.

Although some mutual funds sell their shares without a sales load -- the so-called "no load funds" -- the overwhelming majority of mutual fund shareholders invest in "load" funds. The sales load is by far the most significant charge paid by these investors. Generally, the sales load is 8.5 percent of the total price the investor pays, or expressed another way, 9.3 percent of the net amount invested. (Commissions and markups on exchange and over-the-counter transactions are expressed as a percentage of the net amount invested.) Quantity discounts are frequently available, generally for purchases of $10,000 or $25,000 and above. */

No part of this sales load goes to the fund for investment or to help defray its expenses. Instead, it is divided among the principal underwriter, who is usually associated with the sponsor-manager of the fund, retail dealers and their salesmen. Certain funds, including

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*/ In a limited number of cases the breakpoint is $5,000, but these discounts are beyond the reach of the average mutual fund investor.

some of the largest, are sold by what is referred to usually as a captive sales force, that is, persons who are employed by, or associated with, the distributor to sell the shares of one or a group of associated funds, but otherwise are not engaged in the securities business. Although the division varies greatly, the underwriter typically receives 2 percent, and the retail dealer gives his salesmen one-half of the 6.5 percent the dealer retains. These amounts are substantially higher than the commissions or markups charged in stock exchange or over-the-counter securities transactions.

Commissions on stock exchange transactions are based on a schedule of minimum commissions, which is substantially identical for all the national securities exchanges and which is approximately 1 percent of the purchase or sale price for all except the smallest transactions. This commission, however, may be divided among several member firms who participate in the consummation of the transaction. If the firm which receives the customer's order has no member on the floor of the exchange, as is the case with most "out-of-town" firms, it must pay about 30 percent of the commission to the "floor broker" and clearing firm who execute and clear the transaction and perform related services in connection with the order. This means that the "out-of-town" firm's compensation on exchange transactions, for all practical purposes, is less than one-tenth of that available on mutual fund shares.

The compensation structure for transactions in unlisted, or "over-the-counter" securities is different from that for listed securities. There is no minimum commission rate; indeed, under the Securities Exchange

Act, no minimum commission rate may be established for over-the-counter transactions. The broker-dealer has a choice whether he will execute the transaction as agent for his customer -- and disclose his commission, which usually approximates the stock exchange commission -- or sell to his customer as principal -- charging a markup which under current rules need not be shown separately on the confirmation and which is usually several times as large as a stock exchange commission and may be as high as 5 percent for certain types of securities. For securities of a quality comparable to mutual fund shares, for example, shares of banks and insurance companies, utilities and established industrials, the markup is around two and one-half percent. Most frequently, and increasingly, however, the broker acts as agent.

In a public offering of securities the underwriting commission or spread is a matter for negotiation between the issuer and the underwriters. It may vary from less than 1 percent, in an offering of high-grade debt securities, to 10 or 15 percent or even more in the case of a highly speculative or local issue with no established market. During the offering, which may last only a few days, but may go for weeks or more, those who participate in the distribution are customarily bound by an agreement not to sell below the public offering price, which includes the agreed markup (which they may, however, abrogate, for example when the issue is "sticky"). Except in the case of so-called "best efforts" underwritings, the underwriters are generally obligated to purchase the entire issue, whether or not they are able to sell it

all, and the level of markups on underwriting reflects, among other things, this "risk-taking" factor, a factor which does not exist in the distribution of the shares of a mutual fund.

The compensation structure for selling mutual fund shares differs from all of the foregoing situations. There is almost no secondary trading market for mutual fund shares. Broker-dealers buy mutual fund shares as principal from the distributor of the particular fund and resell them to investors at a markup which is specified in the fund's prospectus. Indeed, under current rules they may not buy them before they have sold them. In other words, they may only fill orders. This rule, of course, is intended to prevent dealer speculation. These are completely "riskless" transactions, unlike the situation found in customary underwriting or where a dealer makes a market in a particular security, that is, where he is prepared to buy and sell and assume the risks normally inherent in changing market prices. The typical markup specified in the prospectus of a mutual fund distributed through dealers is, as I mentioned, approximately 9.3 percent of the amount invested, in a typical transaction.

The 6.5 percent or more that the dealer can expect to receive out of the markup on mutual fund shares (after deducting the distributor's share) does not, however, exhaust the pecuniary rewards of selling that particular kind of security. As I noted, the national securities exchanges have established minimum commission rates to be charged to customers who buy and sell securities on those exchanges. This minimum commission rate remains approximately 1 percent of the purchase or sale price of the securities, no matter how large the transaction. Broker-dealers,

however, are willing to execute large transactions involving a substantial number of shares for considerably less; in fact, a group of dealers who are not members of the New York Stock Exchange are doing just that in handling large and smaller transactions for institutional and other investors. But if the transaction is executed by a New York Stock Exchange member, it must be executed on an exchange, and the minimum commission rate must be charged. The member, however, need not keep the entire commission; he can "give up" any part of it to any other member firm. If the customer is a mutual fund -- and mutual funds are active traders of large blocks of listed securities -- the executing broker may be required by the fund manager to "give up" a portion of the commission -- often 60 percent or more -- to other member firms as a reward for their sales of fund shares. The directed give up is also used to pay for other services. To reward sellers of fund shares who are not members of the New York Stock Exchange, the broker may be directed to execute the transaction on one of the regional exchanges on which the particular security is also listed and which permits its members to "give up" part of their commission to persons who are not members of the stock exchange. These persons are usually members of the National Association of Securities Dealers but in some cases others such as banks. By this circuitous route, the commissions on the portfolio transactions of mutual funds, paid for by the fund shareholders, are available to provide extra compensation for the sale of fund shares. This extra compensation may be substantial.

The disparity between the compensation available for selling mutual fund shares and that available for selling other securities has consequences

which extend far beyond the matter of costs to mutual fund investors. Not unexpectedly, these disparities may lead firms and their salesmen to recommend and sell fund shares rather than other securities, and frequently the shares of one or related funds which provide the greatest rewards for the sales effort. While mutual fund shares are a valuable medium for equity investment they are not under all circumstances, and for all persons, the only desirable medium. An important problem which springs from this situation is the possibility that the judgment of securities firms and their salesmen as to what type of security, or which particular fund, is best for the particular customer may be influenced, even subconsciously, by major differences in sales compensation. We suggested in our report that some degree of equalization in the level of compensation for selling different types of securities may, without deterring the active sale of mutual fund shares, avoid a possible distortion of investment decisions in the allocation of savings among the various equity media and the resulting impact on the functioning of the markets for reasons extraneous to relative investment merit.

These hard facts of life raise certain questions: How did this situation arise? And what, if any, legislative changes should be made?

The disparity in compensation is undoubtedly due in no small part to the differences in the statutory treatment of commissions and markups. Minimum commissions on the stock exchanges are established by the exchanges subject to review by the Commission. Section 19(b) of the Securities Exchange Act requires that the minimum commission rate on exchange transactions be reasonable. Although there is no minimum or

fixed commission rate for over-the-counter transactions, and indeed the Exchange Act prohibits such rates, Section 15A of the Act does provide that a registered national securities association -- the National Association of Securities Dealers Inc. is the only one -- must have rules designed to safeguard against unreasonable rates of commission. It is pursuant to this provision that the NASD has adopted the 5% markup policy to which I referred earlier. The Commission, of course, has some supervisory responsibility over the NASD and also regulates broker-dealers who are not members of the NASD or of an exchange. Below the range of what I will describe for convenience as unreasonable rates, however, the commissions or markups in over-the-counter securities transactions and in the distribution of securities generally are left to the forces of competition.

Sales loads in the sale of the shares of mutual funds are not subject to statutory requirements that the rates be reasonable. When the Investment Company Act of 1940 was adopted, mutual fund assets were only a small fraction of their present total of almost $40 billion. They were essentially a new medium of investment which had not yet become popular with investors. Apparently in view of the Commission's opinion in 1940 that the sales load question should be left "for the present at least *** to competition among the different distributors", the Act provides authority to the NASD and the Commission to regulate sales loads on mutual funds only if they are unconscionable or grossly excessive, a standard which has not proved useful. The 1940 Act does provide, however, that sales loads on periodic payment plans, the so-called front-end load plans, shall not exceed nine percent of the total

payments made if the investor completes his payments over the specified life of the plan, usually 10 to 15 years.

Competition might well have reduced sales loads as the Commission anticipated in 1940 were it not for the unique resale price maintenance provisions of Section 22(d) of the Act. That Section prohibits dealers from selling mutual fund shares to the public "except at a current offering price described in the prospectus," a price fixed by the distributor of the fund shares who is normally associated with the manager. This provision effectively prevents any price competition in the shares of a particular fund at the retail level. As a result, competition in the mutual fund business has not resulted in lowering the sales load to attract investors but rather has resulted in raising the sales load to provide a generous compensation level to attract dealers and salesmen. This reflects the view generally expressed that mutual funds are sold not bought.

Section 22(d) is a unique form of fair trade law. Although the Commission has certain exemptive authority, the Commission has the responsibility of enforcing the charging of fixed sales loads without any authority to control their amount, except to assure that they are not unconscionable or grossly excessive. A retail dealer who wilfully sold mutual fund shares below the prices stated in the fund prospectus could have his broker-dealer registration revoked by the Commission. This should be compared with State fair trade laws, which leave enforcement to the private parties involved.

Whether or not higher than normal sales charges were necessary to promote sales when mutual funds were a relatively new and not widely

accepted infant industry, there can be no question that the funds have now reached maturity. It is interesting to note in this connection that the recent Booz-Allen study prepared for the NASD reported:

> "the partners of numerous firms in the five cities visited during the course of this study *** pointed out that their salesmen typically had to work much harder to sell over-the-counter stocks than mutual fund shares."

These factors and others considered by the Commission led it to recommend to the Congress that sales loads not exceed 5 percent unless the Commission found a higher load appropriate.

An alternative which was carefully considered and which to some of you seems more attractive would be to repeal the price maintenance provisions of Section 22(d) and thus allow retail dealers to compete more freely for investor favor. Representatives of the mutual fund industry, however, have strongly urged that this would disrupt the existing system of distributing investment company shares; that unbridled competition might put the industry in a net redemption situation with consequent dangers to investors and the markets for equity securities. For reasons stated in our report, the Commission determined not to recommend that Section 22(d) be repealed.

I want to make clear that our recommendation for lower sales loads is not based on any assumption that all mutual fund dealers and all salesmen make too much money. The existence of a high sales charge, protected by retail price maintenance, has drawn a very large number of dealers and salesmen into the field, many of whom limit themselves largely to

the sales of fund shares. Indeed, it has been suggested that the artificially high and protected level of compensation for selling mutual fund shares may have drawn into that activity so many salesmen there are no longer enough customers to go around. There may be as many as 50,000 mutual fund salesmen operating at present. That is equal to about one salesman for every 70 mutual fund investors. It has been urged that if our recommendation is adopted, it may have the effect of reducing this number of salesmen. While I question whether this would be so, advances in the law and the protection of investors and the general public interest often mean some small change in the status quo. However, I wish to emphasize that I personally do not believe that there will be any serious unsettling effects. In fact, mutual funds will be an even more attractive medium for those who are interested in funds because the costs of acquisition will be lower. This will undoubtedly lead to greater need for competent brokers and dealers interested and engaged in the sale of fund shares.

To sum up, the unhappy facts are that price competition, at least for the shares of a particular fund -- which in other business contexts, normally regulates the number of people engaged in any business and the prices charged for commodities or services -- is not permitted either by the statutes or the practices in the mutual fund business. We do not believe that the existing situation is good for the industry or for the country. We do believe that the solutions we have proposed are constructive and give effect to the conflicting considerations involved.