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THE MINORITY MENACE TO MUTUAL FUND SELLING

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It is often said that mutual fund shares are "sold, not bought." Should this be true it could reflect the existence of a regrettable over-intensity of selling effort which could have unfortunate consequences for both the investor and the mutual fund industry. For my part, I would hope that fund shares are more often "bought" than "sold." This must be true in many instances, for the mutual fund share as an investment medium has several unique features of sufficient attractiveness to merit the careful study of anyone developing an investment program. But whatever be the fact, one can hardly doubt the propriety of a continuing inquiry into how fund shares are sold and the further inquiry of what, if any, remedial measures are necessary.

I am confident that many selling practices have appalled the mutual fund industry, their underwriters and dealers when they have been called to their attention. Indeed, those which will be cited as illustrative today would distress anyone of good conscience. They will not be cited as generally prevailing or generally condoned. Certainly they will not be cited for the purpose of embarrassing the industry but rather to alert it. Unsavory selling of mutual fund shares, while not the majority rule, occurs frequently enough to be disturbing. If permitted to continue even infrequently it will constitute a minority menace to the industry and all those interested in it by a gradual erosion of public investor confidence.

The first illustration may strike some as innocuous or even humorous. It is contained in a rather elaborate and handsomely packaged sales training kit. Among other things, the salesman is taught to prepare the "prospect's mental stage" by providing him with canned approaches to persons in varying walks of life. For the young mechanic the salesman is told to ask:

"Do you own this garage?"

"Oh, no," he says. "Old Mr. So-and-so owns this garage."

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"'Would you like to own it some day?'

"The young mechanic laughs. 'Why, it would take over \$50,000 for me to buy this garage.'

"'How would you like to have the \$50,000?'

"The tools drop, the young man stands up. You have his complete attention."

To me this is neither harmless nor funny, for the dominate theme of this and the other recommended approaches is emotion. Concentration on emotion, if successful, can only obscure rather than inform the individual of the nature of the investment vehicle to which his savings are to be entrusted.

Emotional concentration is not a rare mutual fund sales training device. To the contrary suggestions of emotional stimulation proliferate throughout training literature. Indeed one fund executive explained that his organization had three methods of overcoming a prospect's objections. The first -- and certainly inferentially the least important -- is logical. After stating that the second is "half logic, half emotional," the fund executive said:

"The third way is purely emotional, and in our mind far the best."

Even if training examples of the emotional approach seem mild, a serious potential of danger exists. When the bulk of a salesman's training is keyed to an emotional pitch, when he is repeatedly assured that this is right and proper, who can tell how far he will go when turned loose without supervision upon the unsophisticated investor. It is hard to escape the conclusion that the inevitable result will be the "hard sell." In my view the "hard sell" has no place in any phase of the securities business and particularly in the sale of mutual fund shares.

I have said this before and have been taken to task for it by one prominent fund executive. He insisted that the only proper method in the case of fund shares is the "hard sell." His theory was that no amount of explanation can sufficiently explain the nature of the fund share to the prospective purchaser, and it is such an intrinsically desirable investment that he should be induced to buy whether or not he understands what he is buying. The same executive told me that he will not hire a salesman who has any knowledge of the securities business because it will divert him from a proper sales approach. Apparently even a lot of securities knowledge is a dangerous thing.

Lest there be doubt about the likelihood of the "hard sell" consider this gimmick. One sales training organization urges an extensive wife-help program. A variety of imaginative ways are suggested "to win the wholehearted support and understanding of the salesmen's wives." The wives are gathered together and the recommended opening line of welcome is a wife warming "This is the most beautiful sales meeting we ever had." After other such satisfying preliminary observations as "I believe in the old adage that behind every successful man there is a woman," the business at hand is reached. Mutual funds are extolled, wives are encouraged to carry sales literature in their purses for distribution at every opportunity, and they are solemnly advised:

". . . evening appointments cannot be avoided and must be encouraged. Every time a Mutual Fund salesman spends an idle evening or Saturday he is actually depriving some people of the salvation he can offer . . . is depriving himself and his family of the opportunity to move upward financially."

By this time the stage is set for the coup de grace. This requires props, among them a mink stole. The mink and other wife-snaring items are price tagged, not in dollars, but in units of the husband's average sale. The supervisor conducting the meeting is then instructed to display the mink, saying:

"Take this mink stole, for example . . . 6 extra sales and it has been paid for."

"This is not a contest. These are not prizes. This is simply a means of showing all of you how several extra sales each week can help you realize some of your own fondest dreams while making the dreams of the future more likely to come true for those clients who make these sales possible."

Is it any wonder that the "hard sell" results? The salesman may resist training specifically designed to imbue him with emotionally charged selling concepts. Perhaps he can retain balance during the prodding of his supervisors. But who can long remain aloof to a wife with visions of mink so easily attained?

So much for this type of training. More important is where it can lead. Unhappily it all too often leads to extravagant claims, deceptive hucksters, outrageous devices and outright fraud.

For extravagant claims, this one is hard to match. The investment company salesman called upon a young mother. One must admire his ingenuity -- though not his selling pitch -- for he obtained her name from a newspaper birth announcement. In describing the income that would ultimately be available for the infant's education on the assumption of a periodic investment totalling \$50,000 he was asked how much income would result if the market dropped and only \$45,000 remained. His answer was quick and confident. "Impossible," he said. "If that ever happened it would mean that this country had gone Communist. And this country will never go Communist, for there is too much religious fervor here for that to happen." I should add that the salesman did not score. Upon being solicited for the appointment the young mother saw no reason to mention that she was a financial analyst on my staff at the Securities and Exchange Commission.

A saleslady who did score managed to deceive a long time friend of my family with a quite common dodge. She sold the family friend shares of an income fund shortly before the annual income distribution date. In relating the story to me the family friend, a woman of intelligence and business experience, was still enchanted with the saleslady. I was told, "Mrs. X, the saleslady, did a wonderful thing for me. She told me that if I bought now I would get the income distribution in a few weeks and that it was just as if I had invested a year ago and had my money working all that time." Mrs. X did not, of course, explain that the asset value paid for by my family friend reflected the forthcoming distribution and that she was paying for every cent of that distribution. But I wonder if Mrs. X is the one primarily to be blamed here. Before commencing mutual fund selling Mrs. X had been a short order cook for years. Knowing Mrs. X I doubt if she had the ingenuity to invent the device herself. It is even possible that she believed her own sales pitch. I cannot avoid the suspicion that the device was implanted by supervisors. If I am right that sales structure cannot be too strongly condemned.

For outrageous practices, this one is close to the top of my list. The outrage is compounded because a well known training organization blessed it by paying \$25 for the privilege of using it, together with a picture of its salesman-inventor, in their published case histories and encouraged its use. The situation arises when the prospect has been sold on a systematic investment plan. All terms have been agreed upon except that nothing has been said about the amount to be invested monthly. The salesman asks no questions and continues to fill in the application. When he reaches the monthly amount he fills in \$250. Then, we are told:

"The prospect usually stops him in a hurry.

"'I wasn't planning on that much,' he may say apologetically.

"The most I can make it would be \$100 a month."

"[The salesman] smiles and corrects his mistake. The client often cuts down the total . . . but [the salesman] finds it starts him thinking big. Where he might have said \$50 a month . . . he may make it \$100. He'll invest the minimum he had in mind in any event and frequently he'll increase it."

I wonder how well that salesman blends into the credo for mutual fund salesmen recommended by the same training organization that published his case history. That credo, in its least emotional part, asks the salesman to be proud to say:

"Mine is the privilege of speaking the truth, revealing where there are risks of loss as well as possibilities of profit, detailing each item of cost, spurning exaggeration and misleading suggestion, holding nothing back. . . . Mine is the task, the proud, satisfying task, of being a need finder, an educator, a guide."

I do not suggest that there is impropriety in a salesman having enthusiasm for his product. I would not expect sales success to result from a robotistic cold computer presentation. But I do suggest that the enthusiasm cannot get out of hand where the product is a mutual fund share or any other security. Here the salesman must be scrupulously fair; he cannot be deceptive; he must consider his customer's need and financial capacity. His responsibility far exceeds that of salesmen of other wares. Caveat venditor, not caveat emptor, applies here.

There are many other examples of over-enthusiasm leading to irresponsibility. For present purposes one more will suffice. A complaint too often encountered is the sale of contractual plans without sufficient or, indeed, any explanation of the heavy front-end loading charges. Some purchasers, including a 72-year old widow, claim not only to have been unaware that as much as 50% of their first year's payments disappear into sales load but they also profess to have understood that theirs was a single purchase and not a contractual plan providing for ten annual payments, each equal to the amount of their single purchase.

In fairness I should acknowledge that investigations of these and other complaints often leave us in a haze area. We recognize that disappointing investment results can color the purchaser's recollection

of what he was or was not told by the salesman. On the other hand, perhaps our investigators can be forgiven for a certain skepticism developed through a long and consistent history with salesmen who proclaim the purity of their presentation and motives. And we hope it is not cynicism that sometimes causes further probing notwithstanding the proud display of a paper record of documents duly signed by the complaining purchaser. Though the contractual plan application may recite that the purchaser has read and understood the prospectus, though a correlary document may acknowledge complete understanding of the heavy load, this is not necessarily conclusive. Carelessness, ignorance, deceptively induced enthusiasm and sales mesmerism are not uncommon reasons for signing documents without comprehension of their contents.

Regardless of purchasers' assertions and salesmen's denials, I believe these two observations are reasonable. First, in view of the heavy loading charges incurred in the early years of a contractual plan, the salesman should be held to particularly high standards of conduct. Second, it would be rare if the sale of a contractual plan to an elderly person of modest means did not constitute reprehensible conduct per se. If contractual plans have any investment or other merits -- a point I am not prepared to concede -- certainly they have none here. I would not consider application of these observations harsh. Heavy loading means richer rewards to salesmen and a stimulus to over-sell. Imposition of more rigid restraints should be accepted in return for the richer rewards.

Who properly should bear the responsibility for poor, misdirected or total lack of sales training and for those salesmen who engage in unsavory practices? Clearly the dealer cannot evade responsibility, for it is he who directly or through his employees has the customer contact. In the same category are those underwriters which have so-called "captive" sales organizations and whose employees also have direct customer contact.

But what responsibility has the conventional mutual fund underwriter which has no captive salesmen and which sells through dealers? In my opinion the conventional underwriter has at least equal responsibility. It is incumbent upon this type of underwriter to select his dealers with great care. Mass and random mailing of dealer agreement forms -- a practice not unknown in the mutual fund industry -- cannot be condoned. An underwriter has the obligation to know -- and know intimately -- those with whom dealer agreements are signed and the nature and quality of the dealer organization. It would be, in my opinion, a serious dereliction of duty for an underwriter to use a dealer without investigating sufficiently to be satisfied that the dealer is staffed with well-trained, capable salesmen.

Unhappily, this does not always occur. A district Business Conduct Committee of the National Association of Securities Dealers was moved to inquire in a recent decision:

". . . we wonder how many investment company sponsors bother to investigate those to whom they offer their sales agreement."

Well may they wonder. The dealer involved in the decision accepted money to buy mutual fund shares and pocketed the money. His listed assets upon originally entering business as a dealer were \$654.95. His gross capital revealed by three separate N.A.S.D. examinations never exceeded \$250. At the time of the N.A.S.D. action the dealer's total assets consisted of one dollar in a bank account. Although the customer had ordered and paid for his fund shares, the mutual fund underwriter disclaimed any responsibility on the technical ground that "their sales agreement states that the dealer is not to act as their agent and that sales are to be confirmed to the public on a principal basis only." As to this the District Committee decision observed:

"We believe that the use of such sales agreements is an attempt to circumvent a liability that a sponsor might otherwise incur under agency law. We feel quite certain that, in the eyes of the public, a dealer and/or his sales representative appear to be acting as agents for the mutual fund they retail and it is a reasonable assumption on the customer's part that he should be able to look directly to the principal for restitution."

I can only add that where, as here, the dealer selection was grievously derelict restitution on the basis of moral, if not legal, obligation would not seem inappropriate.

Finally, what responsibility, if any, should be borne by the mutual fund directors for inadequately trained salesmen and improper selling methods. No one would expect a director to himself review the qualifications of each salesman or personally spot check sales performances. Nor can the director actively participate in the management of the underwriter. Does it follow, therefore, that the fund director is immune?

I say no. The fund directors are the creators of the sales relationship. By Section 15(b) of the Investment Company Act of 1940 an underwriter cannot lawfully act for a fund without a written contract.



That contract must be authorized by the fund directors or submitted by them for the approval of stockholders. Similarly, it must be annually approved. Certainly the Investment Company Act does not contemplate annual approval of the underwriting contract by directorial rote.

A properly functioning director will make some inquiry prior to casting his annual vote of approval. More than that, he should continuously review the performance of the underwriter and demand some means of becoming informed of complaints. The latter may not be easy, for a fund underwriter might have a natural -- though not justifiable -- reluctance to inform directors of complaints. But it can be done. And if there is undue reluctance the services of the Commission's staff are available.

In the course of our current permanent staff studies of the structure of the investment company industry,\* we have had occasion to interview many mutual fund directors. On the whole we have been impressed by their qualifications and conscientious desire to perform in the best interests of their shareholders. In some instances, however, we have found even in well qualified conscientious directors a distressing lack of knowledge of their fund operations. This is particularly true of the distribution process of the fund. For these men an educational process is certainly in order, and I am confident they would welcome it. And in general a more active interest in underwriting operations by fund directors would be salutary.

In the overall, the mutual fund industry has a history of which it can be proud and a future with unusual potential. My observations today are in no way intended as an industry indictment. As I noted at the outset, my examples do not generally prevail; they exist in minority. But even a minute minority can menace a potentially great future. Wisdom dictates that every effort be made by both the industry and our Commission to sterilize these few seeds of destruction.

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\* This is not to be confused with the Special Study of Securities Markets which has examined certain phases of the mutual fund industry relating primarily to the securities distribution process. The study referred to in the text is being conducted by the Commission's Division of Corporate Regulation and is a comprehensive structural examination of the industry.