CHAPTER XI

OPEN-END INVESTMENT COMPANIES

(MUTUAL FUNDS)

A. Introduction

1. THE GROWTH AND STRUCTURE OF THE MUTUAL FUND INDUSTRY

In the 23 years since the adoption of the Investment Company Act, open-end investment companies, more commonly known as mutual funds, have experienced an extraordinary growth and popularity. The Investment Company Institute, a voluntary association whose members account for the bulk of the assets of mutual funds, since 1941 has seen 68 open-end member funds with $401 million in total net assets increase to 169 open-end member funds with over $21 billion total net assets at the end of 1962, a decline from a peak of nearly $23 billion total net assets at the end of 1961. The number of shareholder accounts in member funds increased from approximately 300,000 in 1941 to almost 6 million in 1962, representing approximately 3 million shareholders or roughly one-sixth of the total estimated stockholder population of the United States. These represent increases of over 5,000 percent in total net assets and over 2,000 percent in shareholder accounts. The mutual fund growth rate has far exceeded the rate of the investment company industry as a whole. The total assets of closed-end investment companies, which overshadowed the mutual funds in size when the Investment Company Act became law, have increased only from roughly $2 to $6 billion or by about 200 percent.

Approximately half of the tremendous increase in the total net assets of the mutual funds has been from the sale of new shares, as distinguished from the appreciation in market value of securities held in the funds' portfolios. The sale of these new shares has been accomplished by a sales force which has increased in proportion to the growth of the funds. Of the nearly 5,000 broker-dealers registered with the SEC on February 28, 1962, a total of 1,555—the largest single group—gave as their primary activity the sale of mutual fund shares, and an additional 612 broker-dealers listed mutual fund share sales as a secondary activity. Seventy-nine broker-dealers listed mutual fund share distribution (i.e., wholesale distribution of fund shares) as their primary activity, and another 26 noted it as a secondary activity (table I–10).

While mutual funds have been popular for a number of reasons, it is clear that two unique aspects of mutual funds have substantially contributed to the growth of the industry. These unique aspects are

the redeemability [1] of mutual fund shares and their continuous offering to the public. To understand the impact which these features have had on the growth of the industry, it is desirable briefly to review the institutional and legal structure of the industry as it has evolved under the Investment Company Act.

Basically, all investment companies are companies in which a number of investors have pooled their resources to engage in the business of investing, reinvesting and trading in securities of various types.[2] Investment companies are classified by the Investment Company Act [3] as either face-amount certificate companies, unit investment trusts, or management companies, the last being by far the most significant in terms of numbers and size. Management companies, in turn, are divided into closed-end companies and open-end companies, or mutual funds.[4] An open-end company is defined as one that "is offering for sale or has outstanding any redeemable security of which it is the issuer." [5] This chapter is concerned with open-end companies only, and the Special Study generally did not obtain information relating to fact amount certificate companies, unit investment trusts [6] or closed-end companies.

Mutual fund shares are not traded on exchanges or generally in the over-the-counter market, as are other securities, but are sold by the fund through a principal underwriter, and redeemed by the fund, at prices which are related to "net asset value." The net asset value per share is normally computed twice daily by taking the market value at the time of all portfolio securities, adding the value of other assets and subtracting liabilities, and dividing the result by the number of shares outstanding. Shares of most funds are sold for a price equal to their net asset value plus a sales charge or commission, commonly referred to as the "sales load," and usually ranging from 7.5 to 8.5 percent of the amount paid, or 8.1 to 9.3 percent of the amount invested. A few funds, however, known as "no-load" funds, offer their shares for sale at net asset value without a sales charge.[7] Shares of most funds are redeemed or repurchased by the funds at their net asset value, although a few funds charge a small redemption fee. The result of this pricing system, it is apparent, is that the entire cost of selling fund shares is generally borne exclusively by the purchaser of

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[1] The Investment Company Act of 1940 defines a "redeemable security" as follows:

"Sec. 2(a)(31). 'Redeemable security' means any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."

[2] The Investment Company Act of 1940 defines an "investment company" as follows:

"Sec. 3(a). When used in this title, 'investment company' means any issuer which—

"(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

"(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

"(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

As used in this section, 'investment securities' includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies."

[3] Investment Company Act, sec. 4.

[4] Ibid., sec. 5.

[5] Ibid., sec. 5(a)(1).

[6] Under secs. 4(2), 26, and 27 of the Investment Company Act, all contractual plans are deemed by the Commission to be "unit investment trusts," but for the purposes of this chapter they have been treated as open-end management companies, like the underlying funds whose shares are represented by the periodic payment plan certificates.

[7] There are approximately 30 no-load mutual funds registered as investment companies with the Commission, representing slightly over 3 percent of the total assets of the industry.

new shares and not by the fund itself. In this respect the offering of mutual fund shares differs from, say, the offering of new shares by a closed-end investment company or an additional offering "at the market" of shares of an exchange-listed security, where at least a portion of the selling cost is borne by the company selling the shares.

Mutual funds are required under the Investment Company Act to be continuously prepared to redeem their outstanding redeemable shares,[8] this obligation is taken by the funds to require, or at least to justify, the continuous and therefore unlimited offering of new shares of the fund. It should be noted, however, that the fund shares are generally offered to the public by principal underwriters under underwriting contracts with the funds,[9] and that these principal underwriters frequently have an additional connection with the funds either as investment advisers or broker-dealers or through affiliations with one or the other.[10] Through either connection they have a strong incentive in addition to the profits to be derived from underwriting to increase the size of the funds. The funds' investment advisers are almost universally compensated under contracts which compute compensation as a percentage of the average net asset value of the funds—most frequently one-half of 1 percent per annum of average net assets. A principal underwriter which acts as or controls or is controlled by a fund's investment adviser therefore can increase the compensation of the investment adviser by increasing the net asset value of the fund through sales of additional shares. Similarly, the funds' affiliated broker-dealers earn commission and other income from transactions in the funds' portfolio securities, and the larger the portfolio the greater the number of transactions to be anticipated. Consequently, in addition to the stimulus to continuous offerings created by the redemption requirements, a fund's principal underwriter usually has other incentives to increase the fund's size. Since none of the cost of sales is borne by the funds themselves, there exists no countervailing pressure from the funds to reduce selling costs, and questions of the maximum size at which funds can operate most effectively seem to receive little attention. These stimuli to continuous offerings, without countervailing pressures, have led to the creation of large and continuing sales organizations which characterize much of the mutual fund industry and are responsible for a major part of the sales pressure which concerns the Special Study in this chapter.[11]

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[8] Investment Company Act, sec. 22(e).

[9] Sec. 12(b) of the Investment Company Act makes it unlawful for a mutual fund other than a no-load fund to act as a distributor of its own securities except through an underwriter in contravention of such rules and regulations as the Commission may prescribe. Although the Commission has never promulgated such rules and regulations, it is the universal industry practice that all mutual funds other than no-load funds are sold through a principal underwriter.

[10] In analyzing 163 investment advisers, the Wharton School Report (see p. 99 below) concluded:

"In four cases out of five, investment adviser control groups participate in the sale of shares, in each such instance deriving income directly from underwriting the sale of shares through the adviser itself, or through a parent, a subsidiary, or an organization otherwise affiliated by major ownership interest." Wharton School Report, p. 473.

[11] Some doubt as to the necessity of maintaining a selling organization to offset funds' redemptions is suggested by an analysis of the net sales of shares (sales less redemptions) of a 23-company sample representing 3 primary methods of distribution during the months of January 1961 through December 1962, prepared from data in the files of the Investment Company Institute at the request of the Commission staff. The sample covered 10 funds relying primarily on independent broker-dealer distribution, 10 no-load funds without sales forces, and 3 funds distributing shares through their own affiliated selling organizations. While net sales of all groups declined sharply following the market break of May 28, 1962, in no month did the 23 funds as a whole have redemptions in excess of sales. In September and November of 1962 the 10 funds relying on independent broker-dealer distribution did have an excess of redemptions over sales, but in no month did the no-load funds, without any sales forces, have redemptions in excess of sales.

Other factors related to the structure of the industry also contribute to this pressure. For one thing, the sales organizations are protected by "fair trading" or resale price maintenance in their sale of mutual fund shares under the Investment Company Act, the rules of the NASD, and private sales agreements. The Investment Company Act prohibits any mutual fund, principal underwriter, or dealer from selling the fund's shares to the public at any price other than "a current offering price described in the prospectus."[12] The Investment Company Act also authorizes the NASD to prohibit its members from purchasing mutual fund shares from any mutual fund or its principal underwriter at any price other than the public offering price less a discount computed in conformity with rules established by the NASD.[13] The association under this statutory authorization has adopted a rule which forbids the sale of mutual fund shares by principal underwriters at a discount from the public offering price to anyone other than a dealer who is an NASD member, and then only when a sales agreement is in effect which sets forth the concession to be received by the dealer.[14] The private sales agreements, in accordance with the statute and NASD rules, provide that the broker-dealer retailing a fund's shares shall sell them at net asset value plus the specified sales charge.

In theory, without these fair trade arrangements, a trading market for mutual fund shares could exist, with purchasers buying at prices below the prices stated in the prospectus (net asset value plus, say, 8.5 percent) and sellers selling at prices above the contractual redemption price (net asset value). Prior to the passage of the Investment Company Act, indeed, there was such a market.[15] The fair trade arrangements established by the act, the NASD rules and the private sale agreements now make it extremely difficult for a trading market in mutual fund shares to exist[16] and to provide competition for the large mutual fund selling organizations in the sale of fund shares. While the overall economic desirability of such fair trade arrangements from the point of view of the public may well merit further consideration by the Commission, the Special Study has been able to do no more than note that in the protection they grant to large sales organizations, they contribute to the pressure for sales of mutual fund shares.

Another factor which contributes to the pressures for sales of mutual fund shares is the New York Stock Exchange minimum commission rate schedule.[17] Because that schedule grants no discounts to mutual funds or other large-volume purchasers from the regular public commission charged on the dollar amount of the round-lot unit of trade, the schedule has encouraged establishment of a variety of reciprocal-

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[12] Investment Company Act, sec. 22(d). The objectives of the section "have been described as (1) to insure the orderly distribution of open-end investment company shares, (2) to prevent discrimination or preferential treatment in price among members of the public, and (3) to prevent the cut-price competition which had then been making serious inroads upon the contractual distribution system of the mutual fund underwriting firms." Greene, "The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940," 37 U. of Detroit L.J. 369 (1960).

[13] Investment Company Act, sec. 22(b). The rules must provide that the price to the public does not include a sales load which is "unconscionable or grossly excessive."

[14] NASD Rules of Fair Practice, art. III, sec. 26(c).

[15] See SEC "Report on Investment Trusts and Investment Companies," pt. 3, pp. 856–857, 865 (1940).

[16] Some mutual fund shares are quoted in the National Quotation Bureau sheets at an offering price equal to the price quoted in the prospectus (i.e., net asset value plus sales charge) and a bid price somewhat in excess of net asset value. The market is not believed to be significant.

[17] The schedule is discussed at length in ch. VI.I.

commission and directed-split or "give-up" arrangements which avoid the ban of the NYSE antirebate rule. A mutual fund's investment adviser, which is responsible for the direction of the fund's portfolio transactions, can instruct on NYSE broker-dealer transacting Exchange business for the fund to "give up" a portion of the brokerage commission on a transaction executed by the broker-dealer, and the business is sufficiently profitable to the executing broker-dealer to make it willing to do so. Since the NYSE antirebate rule forbids the return of this portion of the commission to the fund itself, or indeed to anyone other than another NYSE member, the investment adviser will direct that it be given up to some other NYSE member firm which has rendered services relating to the fund. To a considerable extent the services for which compensation is given in this manner consist of the selling of the fund's shares, although give-ups are also directed to firms which provide special research or analytic services to the investment adviser or supply pricing services or other facilities. The ramifications of reciprocal business are further described in detail in part C of this chapter, as well as in chapter VI.J relating to the NYSE commission rate structure, chapter VIII.C relating to block transactions, and chapter VIII.E relating to regional exchanges. For purposes of the present discussion it is sufficient merely to note that the reciprocal business structure adds one more element to the pressure for sales of mutual funds.

The stimuli which various structural elements of the business give to its sales come to their quintessence in the sale of "contractual plans," also discussed in detail in this chapter.[18] The contractual plan, a merchandising method which dates back to 1930, is essentially a long-term program for investing in mutual fund shares on an installment basis, with a substantial portion of the total sales charge paid in advance as a "front-end load." The arrangement, which is both sanctioned and limited by the Investment Company Act,[19] may be contrasted with the so-called "voluntary plan," which also contemplates periodic purchases of mutual fund shares, but with the sales charge paid only as purchases are made. In the salesmen's incentives of the contractual plan lie the greatest potential for unwarranted selling pressures on members of the public.

In the mutual fund industry, then, there exists a marketing system and a management structure unique in the world of securities. The principal elements of the marketing system are a continuous offering of fund shares, a protected market, and a sales load borne by the purchaser—largely in advance for contractual plan purchasers. The unique management structure through the management-advisory contract arrangement basically separates the fund from such normal management decisions as the extent and manner of sale of its shares. The fund in effect delegates this particular decision to an investment adviser which is compensated on the basis of the size of the fund. The result is a structure which produces continuous pressure for more size, and brings more intense sales pressure on less sophisticated investors than is true of the securities business as a whole. The structure of the mutual fund industry and the pressure it creates raise questions of policy concerning the adequacy of the existing regulatory structure for the protection of the industry and the public interest.

[18] See pt. B.7.
[19] Sec. 27.

2. SCOPE, LIMITS, AND METHODS OF STUDY

Anticipating the possibility of some of the problems which the growth of the investment company industry might engender, the Congress in adopting the Investment Company Act authorized the Commission—

> at such times as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation of the effects of size on the investment policy of investment companies and on security markets, on concentration of control of wealth and industry, and on companies in which investment companies are interested. * * * [20]

With this authorization the Commission in 1958 employed the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to undertake the first comprehensive examination of the investment company industry since the Commission's own "Report on Investment Trusts and Investment Companies," which led to the adoption of the Investment Company Act. The report of this undertaking [21] was transmitted by the Commission to the Congress on August 27, 1962. It was broad in scope, covering the structure and control of open-end investment companies, mutual fund growth in the period 1952–58, investment policies, investment company performance, the impact of investment funds on the stock market, open-end investment companies and portfolio company control, and investment advisers of mutual funds. The report concluded that there was little evidence that size per se was a problem at the present time, except to the extent that questions arise concerning the allocation between fund shareholders and investment advisers of the benefits resulting from large-scale operations, and that the more important current problems of the mutual fund industry appeared to involve potential conflicts of interest between fund management and shareholders, the possible absence of arm's-length bargaining between fund management and investment advisers, and the impact of fund growth and stock purchases on stock prices. The report also noted that the sale of fund shares had been the principal means of expanding the volume of assets managed, and raised the question of whether there might be a conflict of interest between a mutual funds' shareholders and the fund's investment adviser as regards the effort that should be devoted to selling shares. It noted, however, the significant omission from its study of an analysis of selling practices, "to determine whether basic canons of conduct in the securities markets have been consistently maintained."

Although the Wharton School Report was not transmitted to the Congress until nearly a year after the enactment of the legislation authorizing the Special Study, the study was aware from its beginning of the scope and nature of the Wharton School's effort. It therefore focused its attention in the investment company field on subjects outside the scope of the Wharton School Report. Issues within the scope of the Wharton School Report are the subject of a comprehensive pro-

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[20] Investment Company Act, sec. 14(b).

[21] "A Study of Mutual Funds," H. Rept. 2274, 87th Cong., 2d sess., also cited in this chapter as the "Wharton School Report." The Wharton School Report is not to be confused with another report of the Securities Research Unit of the Wharton School—on the mutual fund investor motivation survey undertaken by it for the Special Study. The latter report is herein referred to as the "Mutual Fund Investor Survey."

gram of study currently being carried out by the Commission's Division of Corporate Regulation.

Accordingly, attention has been given to those aspects of the industry which relate to selling practices, including the recruiting, training, background and experience, compensation and supervision of salesmen,[22] the nature and motivations of the mutual fund investor, sales techniques and controls over selling practices, the special problems involved in the sale of contractual plans, and the impact of reciprocal business practices, including their effect on selling practices.[23] The study has also examined certain limited aspects of mutual fund portfolio transactions, with particular attention to the potential of conflicts of interest related to insider trading in fund portfolio securities.

As in other areas reviewed by the Special Study, the techniques of its investigation of mutual fund activities were several and varied. Interviews were held with representatives of a number of mutual fund selling organizations of various types, some of whom also testified at the public hearings conducted by the Special Study. Extensive printed material, including both training and selling literature, was also obtained from the industry. Certain information concerning the background, training, compensation and supervision of mutual fund salesmen was also obtained from questionnaires STS-1 and STS-2, described in chapter II.A.3. To obtain information about the characteristics and motivations of mutual fund investors and representations made by mutual fund sales representatives, the Special Study contracted with the Securities Research Unit of the Wharton School of Finance and Commerce to conduct a survey of persons purchasing and redeeming mutual fund shares. This survey made use of Special Study questionnaires denominated "IC-2" and "IC-3" for 450 personal interviews with outright purchasers of mutual fund shares and contractual plans respectively, "IC-4" and "IC-5" for mail questionnaires to 500 purchasers of mutual fund shares and contractual plans, and "IC-6" and "IC-7" for mail questionnaires to 500 persons redeeming mutual fund shares owned outright or through contractual plans. The study has reviewed the analysis of these questionnaires prepared by the Securities Research Unit, which, together with copies of the questionnaires and tabulations of the responses, is annexed to this chapter as appendix A and referred to as the "Mutual Fund Investor Survey." The Special Study's analysis of the payment performance and sales load experience of contractual plan purchasers was based on data obtained from 9 major contractual plans by means of a questionnaire denominated "IC-8". Information concerning interrelationships, policies and portfolio transactions of 51 open-end investment companies was obtained through questionnaire "IC-1" and form A, further information on selected transactions of 28 of these mutual funds and of 1,151 related persons and companies was obtained through forms B and C of IC-1, and detailed trading information concerning transactions in portfolio securities of 8 of the funds was obtained through form D of IC-1.

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[22] Recruiting, training, background and experience of mutual fund salesmen, as well as other salesmen, are also discussed in ch. II.C.

[23] Reciprocal business and give-ups are discussed in relation to the NYSE commission rate structure in ch. VI.I, and in relation to block transactions in ch. VIII.C.

Further information concerning the content of these questionnaires and the manner of selection of their recipients is set forth in the text of the chapter, and copies of questionnaires IC-1 and IC-8 are annexed as appendixes B and C to this chapter.

B. Selling Practices

1. STRUCTURE OF MUTUAL FUND SALES ORGANIZATIONS

The growth of mutual funds has brought with it the development of a vast and complex network of sales organizations through which fund shares are distributed to the public. The network includes large groups of interrelated companies and small independent firms. It contains firms of all sizes which are engaged almost exclusively in mutual fund sales, and firms of all sizes for which the sale of fund shares is only a segment of their general securities business. An outline of the manner in which mutual fund distribution is accomplished and the various types of firms which participate in the distribution is necessary to an understanding of mutual fund selling practices.

As noted in the preceding section, mutual funds generally sell their shares through a principal underwriter, either on a principal or agency basis, rather than directly to the public. Some principal underwriters are part of integrated organzations of one or more corporations, sometimes referred to as "complexes," which perform the principal underwriting,[24] investment advisory[25] and retail functions. Others are not affiliated with retailing organizations and sell fund shares only on a wholesale basis to independent broker-dealers for further distribution to the public. Some combine aspects of an integrated distribution system with elements of the independent distribution system. The sections below describe examples of distribution systems of these various types.

a. Integrated distribution organizations

The integrated distribution organization may be one company or a complex of affiliated companies. It ordinarily has hundreds or thousands of retail sales representatives and includes the principal underwriter for a fund or group of funds with substantial asset values.

Hamilton Management Corp., of Denver, Colo., is an example of a totally integrated organization. The one company combines the functions of sole underwriter for, investment adviser to, and retailer of Hamilton Funds, Inc., an open-end investment company. Hamil-

[24] Sec. 2(a)(28) of the Investment Company Act defines "principal underwriter" of an open-end investment company as follows:

" 'Principal underwriter' of or for any investment company other than a closed-end company, or of any security issued by such a company, means any underwriter who as principal purchases from such company, or pursuant to contract has the right (whether absolute or conditional) from time to time to purchase from such company, any such security for distribution, or who as agent for such company sells or has the right to sell any such security to a dealer or to the public or both, but does not include a dealer who purchases from such company through a principal underwriter acting as agent for such company."

[25] Sec. 2(a)(19) of the Investment Company Act generally defines an "investment adviser" of an investment company as:

"* * * (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) regularly performs substantially all of the duties undertaken by such person described in clause (A); * * *."

ton Funds, Inc., has two classes of shares: Series HC-7, purchased outright by the public, and series H-DA, underlying a periodic investment or contractual plan. Each class of shares is supported by a separate portfolio of investment securities. Both the HC-7 shares and periodic investment plans are sold only by Hamilton Management Corp.'s sales representatives, and these representatives, in turn, agree to sell only Hamilton fund shares and periodic investment plans. The management company does have an unwritten agreement, however, with Surety Life Insurance Co. of Salt Lake City under which the salesmen of each company may be licensced to sell the merchandise of the other if they meet the necessary qualification standards. Hamilton Management officials stated that the arrangement was reached because the company had "noted a movement toward insurance and funds being combined in many ways."

In April 1962, Hamilton Management had the largest sales force in the securities industry, numbering approximately 7,800 salesmen, assistant district managers, and district managers. Most of its salesmen, 6,800 of whom were classified by the firm as "active," sell funds on a part-time basis. In terms of assets Hamilton Funds, Inc., is among the large mutual funds, with assets, on December 31, 1962, of approximately $266 million.

Another fully integrated sales organization is Investors Diversified Services, Inc. (IDS), principal underwriter for five mutual funds with an aggregate net asset value at the end of December 1962, of about $3.2 billion, or about 15 percent of the net asset value of all mutual funds on that date. IDS is different from most large mutual fund retail sales organizations in that almost all (2,783) of its sales representatives, who numbered 2,920 as of April 1962, are full-time salesmen. These sales representatives are the sole distributors of shares of IDS-underwritten funds, and sell no other funds. They also sell life insurance of an IDS life insurance company subsidiary and face-amount installment certificates for a subsidiary face-amount certificate company.

As totally integrated organizations, neither Hamilton nor IDS belongs to the NASD. Since they sell only the funds underwritten by themselves they have no need to be eligible for the dealers' discount in the distribution of securities, to which NASD membership would entitle them. Furthermore, they avoid substantial expenses, since NASD membership fees are computed in part upon the number of sales representatives of an organization.[26] As a result, neither the companies nor their salesmen are subject to the NASD's controls over selling practices. Together these two companies, which are not members of the industry's self-regulatory organization, employed nearly 11,000 salesmen at the end of 1961. By comparison, Merrill Lynch, Pierce, Fenner & Smith, Inc., the Nation's largest general broker-dealer, on the basis of its August 1961 NASD assessment report, had 2,217 registered representatives. All NASD members together had 102,305 sales representatives at the end of 1961.[27]

Another group of major mutual fund sales organizations may be described as primarily but not totally integrated. In these organiza-

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[26] Hamilton Management Corp.'s officers testified in 1962 that it would have cost the company $78,000 to become a member of the NASD.

[27] See ch. II, table II-6, above.

tions affiliated companies perform the primary underwriting, investvent advisory and retailing functions with respect to one or more mutual funds. They are distinguishable from totally integrated operations, however, in that shares of the funds sponsored by the principal underwriter are also sold to the public through broker-dealers independent of the principal underwriter's affiliated retail organization, and sales representatives of the principal underwriter's organization often may be permitted to sell shares of funds other than those of the principal underwriter. Although this arrangement theoretically gives the sales representatives a broader range of merchandise to offer, as a matter of practice sales representatives are encouraged through a variety of compensation and other devices to emphasize the funds of principal underwriters with which they are affiliated.

The Waddell & Reed, Inc. (W & R), organization represents an example of this type of distribution system. W & R is the principal underwriter of four funds (known as the United Funds) and various Canadian funds with an aggregate net asset value of $1.28 billion on February 28, 1963. Investment advice is provided to the funds by Continental Research Corp., 80 percent of which is owned by W & R, and by other investment advisory subsidiaries. About 90 percent of United Funds' shares are sold through W & R's own sales representatives, who numbered nearly 5,000 in April 1962. At the same time, W & R does effect some distribution of the United Funds through other broker-dealer organizations, and W & R salesmen, in turn sell some shares of other mutual funds.

At the center of a similar complex is the Channing Financial Corp., a publicly held holding company. Among its subsidiary companies is Channing Service Corp., principal underwriter of nine mutual funds with aggregate net assets at December 31, 1962, of $345 million. Channing provides investment advice to its affiliated funds through another subsidiary, Van Strum & Towne, Inc. More than 75 percent of the sales of shares of these funds is made by the retail organization of King Merritt & Co., Inc., another subsidiary which, in May 1962, had about 2,200 sales representatives, of whom 35 percent sold full time and 65 percent on a part-time basis. The balance of the funds' shares are sold wholesale to other broker-dealers by Channing Service Corp., the principal underwriter.[28] King Merritt also acts as exclusive national retail distributor of the variable investment plan, a contractual plan the underlying shares of which are one of the Channing funds. Six hundred and fifty of King Merritt's salesmen are also licensed to sell insurance, and sell policies of three insurance companies in which Channing has interests—majority interests in two cases. About 30 percent of the sales of King Merritt representatives are of funds not affiliated with Channing. Thus the Channing Financial Corp. has, like the other organizations described above, an integrated mutual fund underwriting, investment advisory and retail sales organization, but differs from the others in selling a greater proportion of shares of nonaffiliated funds and in having funds underwritten by it sold to a greater extent by other broker-dealers.

[28] Other activities of Channing Service Corp. as intermediary broker-dealer in the purchase and sale of shares for certain of the Channing funds' portfolios are touched upon in pt. C.2.b, below.

b. Nonintegrated distribution organizations

Another important element in the distribution of mutual fund shares to the public is the principal underwriter which sells at wholesale to independent broker-dealers, but does not itself retail shares to members of the public. Such an underwriter often is affiliated with the investment adviser of the funds underwritten by it.

An example of this type of distributive operation is Anchor Corp. (Anchor), a holding company, one of whose wholly owned subsidiaries, Hugh W. Long & Co. (Long), is the principal underwriter of three mutual funds. The investment adviser of the three funds is Investors Management Co., another subsidiary of Anchor. In addition, Anchor owns all the voting stock of First Western Life Insurance Co.

Shares in the three funds are sold by Long, as principal, under a standard selling group agreement which it has entered into with more than 2,500 retail broker-dealers throughout the country, who also usually sell shares of other funds. These independent broker-dealers employ an aggregate of about 20,000 registered representatives. The only standard which a retail broker-dealer must meet to sell shares in Long-sponsored funds is that of membership in the NASD. Long itself makes no effort to investigate the qualifications of these broker-dealers; in only a few instances has it refused to enter into a sales contract with a retail broker-dealer.[29] The terms of the contract, in accordance with the rules of the NASD,[30] require that retail broker-dealers order shares only against purchase orders already received, and the shares must be sold at net asset value plus the specified sales charge.

Long has no retail salesmen of its own. A large retail organization independent of Long, First Investors Corp., sells, through its own retail sales force, contractual plans based upon two of the funds for which Long is principal underwriter. In the spring of 1962 the First Investors Corp. sales force numbered more than 2,600 salesmen. In connection with these contractual plans, Long sells the shares at net asset value to the custodian bank, which purchases them as needed on behalf of the contractual plan. In the case of one of the two plans Long receives a commission from the sponsor of one-sixteenth of 1 percent of the net asset value of the shares purchased.

Long maintains contact with its 2,500 retail broker-dealers through about 20 individuals known as "wholesale field representatives." Their job is to maintain contact with individual retail salesmen and firms and to distribute sales and training material produced by Long for the use of retailers, but they do not themselves sell shares either to these retail broker-dealers or to the public. They are compensated

[29] The problems which limited investigation may generate are illustrated by a recent decision of an NASD District Business Conduct Committee which voted to expel a dealer member for accepting $746 for the purchase of mutual funds and using the funds for his own purposes. His capital at the time of 3 examinations between June 1961 and July 1962 was never greater than $250. The mutual fund's distributor disclaimed responsibility on the ground that its sales agreement with the dealer stated that the dealer was not to act as the distributor's agent and that sales of fund shares to the public were to be confirmed only on a principal basis. The District Business Conduct Committee commented: "In view of the inadequate capital and qualifications [of the dealer], we wonder how many investment company sponsors bother to investigate those to whom they offer their sales agreements."

[30] NASD Rules of Fair Practice, art. III, sec. 26(f) (2), 26(c).

by a part of the commission received by Long on sales in their territory.[31]

An organization combining elements of the integrated and nonintegrated approaches to sales is Investors Planning Corp. of America (IPC). IPC is principal underwriter for periodic payment plan certificates of contractual plans for two related funds—Axe Science & Electronics Corp. and Axe-Houghton Fund B, Inc., and for National Investors Corp., all of which, at the end of 1962, had net assets aggregating almost $500 million. IPC is not principal underwriter of these funds themselves, but it is principal underwriter of two other small funds, Fund of America, Inc., and General Investors Trust. An IPC subsidiary is investment adviser to Fund of America. IPC has a 10-percent interest in Axe Science Management Corp., investment adviser to the fund underlying one of its three contractual plans, and under its agreement as principal underwriter of General Investors Trust, it becomes entitled to receive amounts up to 25 percent of the trustees' investment advisory fee upon meeting certain minimum sales requirements.

IPC retails its contractual plans through 4,700 registered representatives operating out of the main office in New York and 4 branch offices. IPC salesmen sell shares in Fund of America and General Investors Trust, as well as shares in mutual funds other than those underlying the contractual plans for which the corporation is principal underwriter. In addition, IPC wholesales plans through three selected dealers and three distributors, the latter having the exclusive right to sell IPC-underwritten contractual plans in their respective territories.

In the nonintegrated sales operation the independent retail dealers are of primary importance. Normally, they have contracts with many underwriters of mutual funds, and thus are in a position to offer a range of mutual fund securities to the public. These dealers may be general securities firms or may deal solely in mutual funds. About half the business of Long, for example, is with firms which are members of one or more exchanges. Some of the larger exchange member firms have established special mutual fund retailing departments. Bache & Co., second largest member of the NYSE, went so far as to establish special offices for the sale of mutual funds, called investors service centers. At the same time, the number of dealers whose primary business is selling mutual funds indicates that mutual fund retail specialists are a significant element in the mutual fund distribution system. Income figures derived from questionnaires STS-1 and 2 [32] give further confirmation of the fact that retailing of mutual funds is to a considerable extent a specialized business. Thus, among the 83 firms in the STS-1 and 2 sample which derived more than half their gross income from mutual fund sales, the average percentage such income bore to total income was 87 percent. Other firms derived an average of only 9.7 percent of their gross income from mutual fund sales.[33] Moreover, responses to questionnaire OTC-3 indicated that of the firms which were primarily engaged in retailing mutual fund shares, half engaged in no other phase of the securities business.[34]

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[31] Another large wholesaler of mutual funds is Vance, Sanders & Co., Inc. of Boston, wholesaler, through more than 2,500 retailers, of 5 funds. The company has a minority interest in the investment adviser of 2 of the funds.

[32] See explanation of STS-1 and 2 in app. A to ch. II.

[33] See table XI-1.

[34] See ch. I., p. 17 (pt. 1).

Other figures from questionnaires STS-1 and 2 indicate that, like the integrated mutual fund distribution organizations, nonintegrated retail mutual fund dealers often sell both mutual funds and life insurance. Among 63 small and medium-sized firms specializing in sales of mutual funds,[35] 42 (or exactly two-thirds) permit their sales representatives to sell life insurance. This practice appears less common among firms in the general securities business. Of 32 small and medium firms in this category, only 7 (or 21.9 percent) permit their registered representatives to sell life insurance.

2. THE MANNER IN WHICH SHARES ARE SOLD AND REDEEMED

Regardless of the structure of the sales organization engaged in the distribution of fund shares, there exist established patterns in the sale and redemption of shares which are common to the entire industry.

a. Sales charges

As has been noted, almost all mutual funds are engaged in a continuous offering to the public of new shares. These new shares are acquired from the funds at net asset value by their principal underwriters under exclusive distribution agreements. The principal underwriter then sells the shares either to the public through its own retail sales organization, or to a dealer who in turn retails the shares to the public, or through a combination of both methods. Since about 1960, sales by fund underwriters, whether to dealers or the public, have generally been on an agency basis. The prior practice of having the underwriter purchase as principal was designed to insulate the fund from liability for the underwriter's selling activities. The cost of this practice was the Federal transfer tax imposed on the sale by the underwriter.[36] Whether or not the underwriter acts as agent, retail dealers continue their prior practice of purchasing as principal and reselling the fund shares to the public. This practice is followed in an attempt to insulate the fund and the underwriter from responsibility for the dealer's selling activities. Each such transaction by a principal underwriter or dealer who is a member of the NASD is, in effect, however, a riskless transaction, since the NASD Rules of Fair Practice provide:

> No member shall purchase the securities of any open-end investment company of which it is the underwriter from such company except for the purpose of covering purchase orders already received and no member shall purchase such securities from the underwriter other than for investment except for the purpose of covering purchase orders already received.[37]

The individual public purchaser of mutual funds pays the offering price per share stated in each fund's prospectus, which for the most part is equal to the net asset value per share plus a selling commission

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[35] In the analysis of responses to questionnaires STS-1 and STS-2, firms deriving more than 50 percent of their gross income from sales of mutual fund shares were treated as specializing in mutual funds, while firms deriving 50 percent or less of their gross income from this source were treated as firms engaged in the general securities business. Firms in each category were further classified as "small," "medium," and "large" firms according to their gross incomes. See ch. II, app. A, table I (pt. 1).

[36] Since the institution of agency sales by underwriters, some funds have protected themselves from liability for the underwriter's selling activities by providing, in the underwriting agreement, for indeminification of the fund by the underwriter or by requiring the underwriter to take out an insurance policy indemnifying the fund.

[37] NASD, Rules of Fair Practice, art. III, sec. 26(f)(2). Since the only transactions in fund shares by non-NASD members are sales to the public by totally integrated sales organizations, such sales are also in effect riskless transactions made for the purpose of covering purchase orders already received.

or sales charge (also referred to as the "sales load" in the Investment Company Act).[38] The net asset value per share is generally computed twice daily on each day when the New York Stock Exchange is open for business. In the computation, each fund portfolio security is valued at its latest reported sale price, or, if no sale price is reported since the prior valuation, at the average of the latest bid and asked prices. Where no market quotations are available, securities are valued at their "fair market value." To the aggregate value of the fund's securities is added the dollar amount of its cash and receivables, its liabilities and accrued expenses are deducted, and the total net asset value thus determined is divided by the total number of fund shares outstanding.

The percentage of sales load added to the net asset value per share in the public offering price varies from fund to fund, and also depends upon the total dollar value of the shares purchased. For most funds it ranges between 7 and 8.9 percent of the total amount paid in smaller purchases, with the most typical charge being 8.5 percent. Expressed as a percent of the amount invested rather than the amount paid, the sales load for most funds ranges between 7.5 and 9.8 percent, with the typical charge being 9.3 percent. For larger purchases completed at one time, or within 13 months under a "letter of intention," the percentage of sales charge decreases with the size of the purchase at various specified levels, often known as "breakpoints." For a few funds, lower rates apply at a $5,000 level; for many others, the charge is reduced at $10,000 or $15,000; in a number, the reduction commences at $25,000. From the first break-point on, further reductions are usually made if a transaction totals $50,000, $100,000, $250,000, or $500,000.[39] While charges and break-points vary considerably from fund to fund, the pattern may be illustrated by the following charges of one reasonably representative fund:

TABLE XI–a.—*Percentage sales charges of a representative mutual fund*

Size of purchase	*Sales charges (as percent of total purchase price)*
Less than $25,000	8.5
$25,000 to $49,999	7.5
$50,000 to $99,999	6.0
$100,000 to $249,999	4.5
$250,000 to $499,999	3.0
$500,000 and over	1.5

In few funds are the charges reduced to as little as 4 percent for purchases of less than $50,000.

The full sales charge paid by the purchaser is usually divided between the principal underwriter and the dealer engaged in retailing the shares, except in cases where the principal underwriter makes the retail sale and itself retains the entire sales load. If the charge is divided, the underwriter receives from one-third to one-eighth of the sales charge, or from 1 to 2.5 percent of the purchase price on smaller purchases, with the balance, or 6 to 7.5 percent going to the retailer. Some principal underwriters which are also general securities firms

[38] Investment Company Act, sec. 2(a)(34). But see below with respect to fund shares sold without sales load ("no-load funds").

[39] One fund maintains a sales charge of 4 percent for transactions involving between $90,000 and $5,000,000, and a charge of ½ percent for purchases aggregating more than $5,000,000.

may allocate a larger portion of the total charge to other retailers when they themselves handle fund portfolio security transactions and do not expect to provide additional benefits to other fund retailers through reciprocal business.[40] One such fund pays its dealers 7.5 percent out of a total 8-percent load.

The portion of the sales charge retained by the principal underwriter is intended to cover its overhead and general administrative expenses,[41] the major portion of the cost of prospectuses, the full cost of supplemental sales literature which it supplies to retailers, and promotional and advertising expenses. The last mentioned may include compensation paid to field representatives or wholesalers of the underwriter. The 6 to 7.5 percent of the total purchase price generally received by the retail dealer is shared by the dealer with individual salesmen who, as will be seen, are almost universally compensated on a straight commission basis,[42] and often with supervisory personnel who may have an "override" on the commission of the salesmen they supervise. The dealer itself generally retains between 25 and 60 percent of its share of the total sales charge, or roughly between 1.5 and 4.5 percent of the total purchase price.[43]

While the sales load structure described above is in general terms applicable also to sales of periodic payment plan certificates or contractual plans as they are more commonly known, important variations and distinctions must be borne in mind. For many periodic payment plans the overall sales charges are the same as the charges imposed on outright purchases of shares of the underlying fund, but for some plans charges are lower, or, in rare cases, higher. The sales load, however, is only part of the cost of investing in a contractual plan, since a planholder also must pay a custodian charge generally amounting to 2 percent of each payment on the plan. A purchaser of fund shares, on the other hand, ordinarily has no custodian fee to pay.[44] The overall cost to the purchaser of a contractual plan with an 8.5 percent sales load who completes all his payments is therefore 10.5 percent of his total purchase price, or 11.7 percent of the amount invested. The most important distinction, however, relates to the advance payment of a substantial portion of the overall sales load on a contractual plan out of the first 12 monthly installments on the plan, a feature frequently referred to as "the front-end load," which is discussed in detail in section 7 of this part.

An important exception to the general pattern of mutual fund sales charges is the so-called "no-load fund," which, as the name implies, is sold to the public at net asset value without the addition of a sales charge. While most mutual funds operate under provisions of the Investment Company Act which require that no more than 60 percent of the members of the board of directors of the fund can be connected with its investment adviser or be officers or employees of the

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[40] See the discussion of reciprocal business in pt. C, below.

[41] See the Wharton School Report, p. 514, where a survey of the operating-expense ratios (as percent of total income) of underwriting activities of 37 corporate investment advisers revealed that the total expense ratio exceeded 100 percent in 16 out of the 37 instances, and in 2 other cases an operating ratio of exactly 100 percent was reported.

[42] See discussion of salesmen's compensation at sec. 3.c, below.

[43] The New York Stock Exchange generally prevents its member firms from giving their salesmen more than 60 percent of the dealer's share of the load. In unusual cases, the Exchange may permit highly successful producers to retain in excess of 60 percent.

[44] See sec. 7.d(2)(a), below, with respect to the few underwriters who offer "voluntary accumulation plans" on a level-load basis with completion insurance, on which a custodian fee is payable.

fund,[45] the statute exempts from this provision open-end investment companies which comply with certain conditions.[46] Among the conditions are the requirements that no sales load be charged on the shares issued by it, than any issuance and redemption charges not exceed 2 percent of the aggregate net asset value involved, and that no sales or promotion expenses be charged to the fund. Some 30 no-load funds complying with these requirements are in existence, of which some were organized by investment counseling firms for the benefit of persons desiring their advice in investing amounts too small to justify the expenses involved in the management of an investment account on an individual basis,[47] and others were organized by broker-dealer firms. Most of these funds charge neither an issuance nor a redemption fee, although some of them charge a redemption fee of 1 percent, which they retain.

No-load companies are, like mutual funds which charge a sales load, engaged in a continuous public offering of their redeemable shares. However, lacking the resources to finance the sales and promotion efforts in which sales charges enable the selling organizations of other funds to engage, these funds are not so well known to the public. A number of their investment advisers place advertisements in magazines and newspapers, but, except for a statement that no load is charged, they are limited by the securities laws to the formal "tombstone" ad.[48] As a result, the largest no-load funds are smaller than many medium-sized funds sold with a sales charge, and, with few exceptions, their aggregate assets are less than $50 million. It may be noted that from the point of view of performance there is no substantial evidence to indicate that no-load funds as a class have been superior or inferior to mutual funds distributed with a sales charge.[49] It is occasionally suggested that no-load funds may operate at a disadvantage during periods of market distress, in that without a sales organization their redemptions might exceed sales and force liquidation of portfolio securities to meet redemptions at a time when such liquidations would not be desirable. Whatever the theoretical validity of this hypothesis, it is not supported by available evidence concerning the sales and redemptions of mutual shares with and without a sales charge following the sharp market decline in May 1962.[50]

Although the Special Study did not concern itself generally with closed-end investment companies, a review of selling charges for mutual fund shares would be incomplete without comparison with the cost of investing in shares of closed-end companies, which, like mutual funds, also often offer the investor the opportunities of diversification of investment and professional management, although not engaging in continuous offerings of redeemable shares. Since their shares are not continuously offered, they are available only on an exchange or in the over-the-counter market, and since they are not redeemable they must similarly be disposed of in those markets. The price at which they are available therefore depends upon the forces of supply and

[45] Investment Company Act, sec. 10(a).
[46] Ibid., sec. 10(d).
[47] Minimum fees for private investment counseling services usually are such as to discourage or prevent the opening of accounts of less than $100,000.
[48] Securities Act of 1933, sec. 2(10)(b), and rule 134.
[49] The Wharton School Report concluded that there was "no relationship * * * between performance and * * * the amount of the sales charge." P. xi.
[50] See pt. A.1., p. 97, note 11, of this chapter.

demand, and is only indirectly related to the net asset value of the underlying portfolio securities. For some years most closed-end investment company shares have sold at varying discounts from their net asset values, so that for the most part a purchaser acquires them for less than net asset value and also sells them for less, but not necessarily at the same discount. Other funds may fluctuate between discount and premium prices.

The charges on purchases and sales of shares of closed-end funds are determined in the same manner as the charges on non-investment-company securities. When they are traded over-the-counter, a commission is charged if the retailer is acting in a broker's capacity, or, if the retailer is acting as a dealer, a markup on purchases (but not necessarily a markdown on sales) within the limitations of the NASD 5-percent policy is charged. For listed closed-end company shares the minimum commissions are usually charged on both purchases and sales, as contrasted with open-end funds, which do not charge for redemptions; but the total of both these charges for a closed-end fund is generally less than the sales load on open-end funds. Thus the total NYSE commissions on the purchase and sale of 100 shares of a closed-end company traded at 20 would be $54 ($27 on each transaction), while the sales charge on 100 shares of an open-end company with an 8.5 percent load and a net asset value of 20 would come to $186, with no charge made upon later redemption.

b. Reinvestment of mutual fund dividends and capital distributions

Most mutual funds encourage their shareholders to reinvest dividends and capital gains distributions in additional new shares (or fractional shares) of their funds by providing an option for automatic reinvestment, terminable at will by the shareholder. The almost universal practice is to impose no sales charge on the reinvestment of capital distributions. As to the reinvestment of dividends, however, the industry is divided. The full sales commission on the issuance of new shares is charged on dividend reinvestments for about half the funds. No sales commission is charged on dividend reinvestment for the other funds, although a small "transaction charge" is occasionally imposed. It should be noted that no sales charge is imposed upon automatic reinvestments of either dividends or capital distributions by contractual planholders, since the Commission determined in 1949 that the imposition of such a charge would violate the provisions of the Investment Company Act relating to contractual plans.[51]

The proceeds of the sales charge on reinvested dividends are received by the fund's principal underwriter, and, as in the case of the sales charge on an original purchase of shares, a portion is allocated to the retail dealer responsible for the original purchase, who in turn may allocate a portion to the individual salesman responsible for the sale. The sales charge paid in connection with the purchase of the original shares is presumed to reimburse the principal underwriter for its costs of preparing sales literature and to compensate both the principle underwriter and any dealer involved for their services in selling the shares. Accordingly, the imposition of the full sales load on the automatic reinvestment of dividends, which transaction involves no additional sales literature or services, raises the question of whether such

[51] Investment Company Act, sec. 27.

a charge does not primarily represent additional compensation for services previously rendered.

The imposition of the full sales charge on automatically reinvested dividends has been justified on the ground that the administrative costs involved in crediting dividend payments four times a year, handling fractional shares and sending confirmation forms to shareholders are items of additional expense which but for the sales charge would be borne by all fund shareholders, without benefit to those who did not automatically reinvest dividends. The justification assumes that these expenses would be borne by the mutual fund rather than its principle underwriter, and ignores the fact that some administrative costs are also, though less frequently, incurred in the automatic reinvestment of capital gains distributions, and provide no benefit for those who do not automatically reinvest such distributions. In any event it is unlikely that the administrative expenses are as great as the full sales charge.[52] The major portion of the sales charge is paid to the retailer, whether or not he performed any work in connection with such reinvestment. In one situation involving two mutual funds managed by the same investment advisor, the older of the two funds charges a dividend reinvestment fee of 40 cents per transaction, while the more recently organized fund charges the full sales commission of 8 percent of the offering price.[53] A member of the board of trustees of both funds has indicated that the older of the two funds originally allowed reinvestment at net asset value, but after some years instituted the transaction fee to cover sharply increased bank charges for carrying out the reinvestment transactions. The trustee has written that when the second fund was organized—

> I guess * * * we just decided to join the crowd and give in to the sales department. The large increase in plan business in recent years has made dealers and salesmen much more conscious of this factor.[54]

c. Redemption of mutual fund shares

As has been noted, a basic feature of mutual funds is the redeemability of their shares.[55] The charters of most corporate funds grant the shareholder the right to sell all or any part of his shares back to the corporation at any time at a price equal to not less than 99 percent of their net asset value, and certificate holders of trusteed funds have similar rights. It is the general practice of most funds, however, to redeem shares at 100 percent of net asset value at the time of redemption, determined in the same manner as in computing the offering price. The principal exceptions are a few no-load funds which charge a redemption fee of 1 percent of net asset value.

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[52] It is also not clear that the administrative costs involved in the automatic reinvestment of dividends are substantially different from the administrative costs involved in actually distributing dividends.

[53] The 8-percent sales commission exceeds the transaction fee, except where the amount to be reinvested is less than $5.

[54] In 1960 the Investment Company Institute (then the National Association of Investment Companies) publicly stated its position that the reinvestment of dividends is a service which investment companies have developed for their investors, that the decision to provide this service is a business decision on the part of investment company management, that the decision as to the scope of the service, and the charge, if any, for the service should also be regarded as a business decision by investment company management, and a rule which would bar a service charge on reinvestment of income dividends (distinguished from capital gains distributions) would be undesirable.

[55] Section 22(e) of the Investment Company Act prohibits the suspension of the right of redemption or postponement of the payment date upon redemption of any redeemable shares of an investment company for more than 7 days, subject to stated exceptions.

Shareholders and contractual planholders may redeem their shares or plant certificates by endorsing and surrendering them to the fund, its principal underwriter as agent, or the custodian of fund shares for plan certificate holders. Some dealers may handle redemption transactions for their customers, and are not prohibited from charging a commission for handling such a transaction, but any such charges can be avoided by dealing directly with the fund, its principal underwriter or the plan custodian.

Contractual plans generally combine a right of partial redemption of up to 90 percent of the underlying fund shares with a right subsequently to purchase the same number of shares at net asset value at the time of repurchase without the imposition of a sales charge on such repurchase, sometimes imposing a service charge on such partial withdrawals.[56] Some plans also provide for systematic or periodic withdrawal plans for retirement or similar purposes on a monthly, quarterly, or semiannual basis. Under such a plan a certificate holder having accumulated shares of a specified minimum value may, for example, appoint the principal underwriter his agent to receive all ordinary income dividends and capital gains distributions, and to make monthly payments of a specified amount, redeeming such number of shares from time to time as may be necessary to make the specified payments until all shares have been redeemed.

3. RECRUITING, TRAINING, AND COMPENSATION OF MUTUAL FUND SALESMEN

Salesmen employed by a large variety of firms of differing types are engaged in the sale of mutual fund shares and contractual plans, including large and small firms engaged in the general securities business and sales organizations of varying sizes which specialize in the sale of funds and plans. Though broker-dealers which transact most of their retailing business in listed and over-the-counter securities other than mutual funds account for a substantial proportion of all mutual fund sales, their problems with respect to recruiting, training, compensation, selling practices and supervision of salesmen are somewhat different from those found in firms specializing in the sale of mutual funds, and are discussed in chapters II and III. The discussion of these subjects here relates, unless otherwise noted, to large-sized firms which specialize in the sale of mutual fund shares and contractual plans. The separate discussion of such mutual fund sales organizations is warranted by the fairly distinct pattern of selling practices which they have evolved, and reflects the fact that these firms account for a great majority [57] of the gross income earned by all firms specializing in the sale of mutual funds and a very high proportion of all contractual plan sales.[58]

The mutual fund industry appears to follow a distinct pattern in the manner in which the bulk of its salesmen are recruited, trained, compensated, and supervised. Many variations exist, of course, from company to company as well as among salesmen themselves. Never-

[56] See sec. 7.d(2)(c), below.
[57] See ch. I, table I-14, above.
[58] The Investment Company Institute has estimated that, in 1962, sales forces of contractual plan sponsors and plan companies accounted for 86 percent and individual broker-dealers for 14 percent of contractual accumulation plan sales.

theless, from a number of industry characteristics which are discussed in the following section, some features clearly emerge.

Mutual fund sales organizations are constantly engaged in extensive programs of recruiting, since in the securities industry, characterized overall by a high turnover rate, the firms specializing in fund sales have the highest rates.[59] Recruiting is largely carried out through the existing sales force—both salesmen and supervisors. Recruits are overwhelmingly drawn from persons totally inexperienced in the securities business, often by deliberate choice on the part of the firms, though persons experienced in sales of other products may be preferred.

The average inexperienced recruit is paid no compensation for his brief initial training period, and continues to work at other employment to support himself during that time. Training is viewed by most selling organizations as having two stages: an initial period of a few weeks when most new recruits have not qualified to sell securities under NASD rules and State regulations, and a subsequent stage when they are learning by actually selling. The objectives of the first stage are four: to provide the recruit with a basic understanding of his complicated merchandise; to equip him with some knowledge of selling and sales techniques; to prepare him to pass the necessary qualifying State and NASD examinations; and to give him some superficial knowledge of Federal and State securities laws and regulations, Federal tax laws, NASD rules and securities ethics. The training program most frequently combines a limited number of hours of classroom or supervisor's instruction with home study of training material supplied by the selling organization.

Once registered with the NASD and licensed by those States requiring registration, the recruit sets forth to sell mutual fund shares and contractual plans on a straight-commission basis. Since the chances are very high that his compensation from commissions will not reach $1,000 a year or $20 a week,[60] he usually continues to have other employment and he will be a part-time salesman. He is encouraged to look to members of his family, relatives and friends for his first sales, and often to purchase a contractual plan himself. Having exhausted this source of sales, many green salesmen grow discouraged by the process of prospecting, and drift away from the industry. Those with greater persistence may commence to earn higher compensation, become full-time salesmen, and graduate to the ranks of supervisors.

The details of the picture and the variations in the patterns are described in the following sections.

a. Recruiting by selling organizations

The efforts which the mutual fund selling organizations must continuously make to maintain and increase their sales staffs become apparent from an examination of the turnover figures revealed in the responses to the Special Study's questionnaires STS–1 and STS–2, which have previously been discussed in chapter II. The figures are most striking among the largest organizations. Hamilton Manage-

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[59] See ch. II, pp. 96–97 (pt. 1).

[60] Fully two-thirds of all salesmen for firms specializing in the sale of mutual fund securities covered by the study's questionnaires STS–1 and STS–2 earned less than $1,000 per annum. See *table* XI–2. Part-time salesmen constituted 66.4 percent of these firms' sales forces. See ch. II, table II–13, (pt. 1).

ment Corp. with a total of 7,874 salesmen at April 1, 1962, had 2,908 new salesmen join the firm in 1961 and 2,081 leave. Investors Diversified Services, Inc., with 2,863 salesmen on April 1, 1962, had 1,107 join the organization in 1961 while 1,063 left. The situation is similar in smaller organizations. Mutual Funds Associates, Inc., of Philadelphia, with 149 salesmen, recruited 70 and lost 53 in the same year. Federated Investors, Inc., of Pittsburgh, added 219 salesmen and lost 322 in 1961, and had a total of 449 in April 1962.

Responses to STS–1 similarly bear out the predominance among those hired of recruits inexperienced in the securities business. At Financial Programs, Inc., of Denver Colo., 302 of 335 who joined the organization in 1961 had no prior securities experience of any kind. At Triangle Investors Corp. of New York City, the figures were 38 inexperienced newcomers out of 52. Renyx, Field Co., Inc., reporting that all of the 123 salesmen who joined its staff in 1961 were inexperienced, noted that experience was "Not advantageous to mutual fund sales." Classified advertisements used by some organizations to attract recruits also stress the lack of need for securities experience. The general indifference to such prior experience has been explained by First Investors Corp. for itself in the following words:

> Experience either in the investment or sales field is not mandatory, since the company expects all representatives to learn and follow its sales methods.

While a lack of securities experience may be even preferred for mutual fund sales recruits,[61] general sales experience in intangibles and tangibles is viewed as an asset in a new recruit, particularly for the sale of contractual plans. For example, the King Merritt & Co. manual on the selection, screening, training, and supervision of salesmen recommends;

> Other things being equal, a prospective Contractual Salesman with a background in distribution of *intangibles* has an edge on a man whose selling experience has been confined to *tangibles*. However, the Salesman who has had experience *in any field requiring systematic prospecting, door-to-door selling, daily record-keeping and customer follow-through* is by all odds the *best* Contractual recruit, whatever he may have sold in the past. [Emphasis in the original.]

The manual also advises persons looking for good prospective salesmen not to overlook cosmetic, brush, roof-and-siding, real estate, storm window, and food-freezer salesmen, or "any in the gamut of *household Salesmen, because* Contractual selling is very often household selling." [Emphasis in original.] Recruiters for Renyx, Field are also advised to ask businessmen to whom they are making a fund sales presentation for the names of the best salesmen who call on them as potential recruits.

Apparently the Armed Forces also provide a fertile recruiting ground for salesmen. Hamilton Management Corp. counted 2,800 of its approximately 7,800 salesmen who had been recruited from the military as of May 1962. Of these, some were in retirement status, but the greatest number were on active military duty, and many of these were preparing for a future after retiring from the armed services, according to the testimony of Anthony R. Tyrone, Hamilton's executive vice president and director of sales. Hugh L. Jamieson, president of King Merritt & Co., similarly noted that his

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[61] See also ch. II, pp. 100–103 (pt. 1).

company employs "many officers in the military who know they are going to be retired in a year or two who are anxious to make the shift over to civilian life into the fund field."

The STS-1 responses also suggests the predominance of recruiting for part-time employment by mutual fund sales organizations, both through the high proportion of sales employees of the responding companies who are reported to sell part time and through the almost universal practice reflected by the responses of providing no compensation for trainees. In only one reporting company, Investors Diversified Services, Inc., was the sales force almost exclusively composed of full-time employees, and this company also paid its new recruits requesting it a draw against future commissions, generally not in excess of $600 per month. For the rest, the mutual fund sales organization which indicated that as many as half of its salesmen sold on a full-time basis was unusual. More representative were such companies as Mutual Fund Associates, Inc., of San Francisco, Calif., for which on April 1, 1962, a total of 504 of its 742 salesmen worked part time, Associated Fund, Inc. of St. Louis, Mo., with 202 part time of a total of 217 salesmen at the same date, and North American Planning Corp., with 556 of its 582 salesmen selling part time. In the aggregate, the sales forces of firms specializing in the sale of mutual funds were shown by the STS responses to be composed of about 66 percent part-time salesmen.[62] With the sole exception indicated above, all of these firms indicated that new recruits received no compensation in the form of salary and draw, but were compensated on a straight-commission basis at such time as they were qualified to commence selling.

The recruiting of uncompensated part-time sales trainees is claimed to have advantages quite apart from its economic implications to the employers. Founders Mutual Depositor Corp. wrote the study:

> It will be noted that a substantial number of representatives are on a part-time basis. The reason for this situation is that we do not pay salaries or drawing accounts to new salesmen and we have found from experience that the part-time man who is already adequately financed, and who may have sufficient ambition to want to improve his earnings, provides us with the highest type of representation.

Walter Benedick, president of Investors Planning Corp. of America, explained in another way his company's policy of encouraging persons to work for the firm as salesmen on a part-time basis:

> We invite people not to quit their present jobs because we want to be fair to them * * * we all have a responsibility to them and their families to give them first the opportunity to find out whether or not they can make a success in our business before they quit their other position.

b. Training of mutual fund salesmen

The mutual fund industry's high turnover rate for salesmen and recruiting emphasis on persons inexperienced in the securities business result in a need to train large numbers of new salesmen each year. For mutual fund retail sales organizations of any size this need has led to the establishment of their own training programs, formal or informal.

Whatever type of training program is given, it is usually divided into two phases. The first consists of discussions conducted by super-

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[62] See ch. II, table II-13 (pt. 1).

visory personnel or, in the case of a few companies, lectures by regular instructors, and a review of certain training material supplied by the company. The second consists of an on-the-job training program in selling techniques and presentations. The nature of these techniques and presentations is discussed in section 4 below. Although there is no industrywide line of demarcation between the two phases, generally the first segment aims at qualifying the trainee as a registered salesman while the second segment aims at teaching him to sell. Since most trainees must pass an NASD or State examination, or both, the first part of the training usually includes general instruction in the nature of securities, with emphasis on the nature of mutual funds, a description of the securities business, a review of NASD rules and the Commission's Statement of Policy on the sale of fund shares, and a limited discussion of the Federal and State securities laws and regulations and the elements of the Federal tax laws. During this phase the trainee is usually expected to study at home the printed materials supplied to him by the company.

On-the-job training is principally designed to provide the trainee with a basic understanding of the particular mutual fund securities he will sell, to imbue him with a fervor for his merchandise and a belief in the need of most persons for a mutual fund investment program, to train him in methods of finding prospective purchasers and of making effective sales presentations without violating the rules of ethical practice, and to teach him the proper use of the dealer's forms. On-the-job training usually follows the first phase, although they are sometimes given concurrently, and often extends for a period after the salesman has been registered by the NASD and any necessary State authorities, since its last stages usually involve a review of the first sales presentations made by the neophyte salesman to actual customers. A few companies require and many recommend that supervisors accompany the novice salesman on his first few calls. More frequently, however, the supervisor's review is based upon the salesman's own version of his presentation.

Industry representatives sometimes emphasize that the training of fund salesmen does not terminate at the end of formal training programs. Salesmen continue to receive instruction through publications periodically supplied by their firms and through sales meetings and seminars. These salesmen are already engaged in unsupervised sales to the public, however, and the publications, meetings and seminars, which serve primarily to stimulate sales (and also to remind salesmen of their legal and ethical obligations) may be viewed as methods of sales promotion as well as training.

Although no two training programs are identical, a review of one firm's program may be used to point up the elements common to most programs and the particulars in which they differ. An example of the training offered to mutual fund sales recruits is the training program of First Investors Corp. (FIC), a mutual fund retail organization over 90 percent of whose sales are of contractual plans, which had 2,637 salesmen on April 1, 1962, of whom 2,218 worked part time. Like most mutual fund retailers, it hires a large proportion of salesmen inexperienced in the securities business. Less than 5 percent of the 1,666 salesmen who joined the company in 1961 had any experience

in the securities business, and less than 1 percent had as much as 6 months' experience.

FIC's response to questionnaire STS-1 indicates that it requires all inexperienced sales recruits to take its 2-week classroom training course, which covers the fundamentals of subjects related to the investment field and is primarily concerned with preparing applicants for the NASD examination. The course, given at the company's New York and New Jersey training centers and at branch offices for those more distantly located, is presented in four separate 4-hour sessions. The 16-hour course covers the following subjects, according to FIC:

First session: Investment companies; public obligations; corporate securities and corporate funded debt (bonds).

Second session: Underwriting practices and the relevant provisions of the Securities Act of 1933; the over-the-counter market and the relevant Rules of Fair Practice of the NASD and Regulation T of the Federal Reserve Board; transactions on registered national securities exchanges.

Third session: Corporate and securities analysis; the Securities Act of 1933; the Securities Exchange Act of 1934; State Blue Sky laws; taxation of dividends and of capital gains and losses; estate and gift taxes; the Prudent Man Rule; the NASD and its Uniform Practice Code.

Fourth session: The Rules of Fair Practice of the NASD and its Code of Procedure for handling trade practice complaints; Regulation T; the SEC Statement of Policy; the Investment Company Act of 1940.

During the preliminary training period the trainee is expected to study certain printed material including a 112-page "Sales Instruction Manual" prepared by FIC,[63] prospectuses of contractual plans and mutual funds sold by FIC, applications and other FIC forms, FIC plan certificates and compilations of definitions of terms used in the various classroom sessions. Home study of these documents is expected to take approximately 16 hours.

After completing the 16-hour classroom course and the home study, trainees return to local branch offices and supervisors for the second training phase. An examination prepared by FIC, called a "dry run test," is immediately given to all trainees; those whose score is less than 90 percent are required to study further the areas of the classroom course in which their performance was inadequate and take the test again. Until a trainee scores 90 percent on this preparatory examination, he is given no on-the-job sales training.

Trainees admitted to on-the-job training meet with their supervisors on a regular basis over 8 weeks for about 5 hours a week. In his first meeting each new salesman is advised of what is expected of him in production quotas, reports, and attendance at his branch office and sales meetings, and is required to fill out various forms. The supervisor instructs the trainee on the differences between voluntary and contractual plans, and gives him an approved form of sales presentation to learn. At subsequent meetings the trainee rehearses his presentation with the supervisor acting as his customer. As homework, in addition to learning his sales presentation, he is given a questionnaire to complete based upon the presentation and specific assignments in NASD study material. He is then given a second preparatory examination, and if he receives a minimum score of 90 percent he is permitted to take the NASD examination.

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[63] The Sales Instruction Manual reprints the Commission's Statement of Policy, certain provisions of the NASD Rules of Fair Practice, art. III of the AMFPS Code of Ethical Business Conduct, and similar material.

Following NASD registration, the trainee receives instruction in prospecting, and makes telephone calls for appointments with a list of prospects, using a written telephone script while his supervisor observes. He is also reminded that his first six sales will be checked through personal interviews with his customers to insure that proper presentations have been made. The first presentations that result from his prospecting are reviewed with his supervisor, who may accompany the new salesman on his sales calls, and the supervisor gives additional instruction on handling objections and obtaining referrals to prospective customers. Thereafter the salesman is free to make unsupervised calls, except that FIC directs its supervisers to make a monthly check of their sales staff on procedures and salesmen are expected regularly to attend sales meetings and prospecting and procedure clinics.

Unlike FIC, a number of large mutual fund retailers devote a portion of their formal classroom training programs to instruction in sales techniques. Waddell & Reed, for example, which conducts a 1-week, 40-hour classroom course, allocates 19 hours to instruction in prospecting and selling. Mutual Fund Associates, Inc., of California, with a 6-hour-a-week, 4-week training program, spends one-quarter of the time on prospecting and selling. Financial Planning Corp. devotes nearly one-quarter of its 3-week, 72-hour classroom program to these subjects. Investors Planning Corp. of America, which has a 2-week, 24-hour mandatory classroom program and a 10-hour optional program, devotes 5 hours of its mandatory program to prospecting and selling techniques and additional time to an analysis of the prospectuses of the contractual plans which it sponsors.

Among fund retailers with smaller sales forces, formal classroom programs are less common. One such firm is Founders Mutual Depositors Corp., which recently had a sales force of 219, of whom 75, mostly inexperienced, joined the firm in 1961. The firm's training program consists of furnishing trainees with several NASD publications: "The NASD and the Registered Representative," "Over-the-Counter Trading Handbook," "Questions and Answers," and a 38-page résumé of definitions of terms. The firm has no regular on-the-job training program for its new salesmen, but states that it provides "irregular but continuous" training in sales procedures.

While some companies, like FIC, themselves prepare all the training materials used in their courses other than NASD materials, a substantial number of companies turn for their materials to one of the two major NYSE firms specializing in the preparation of mutual fund sales training course materials. These firms, which are largely compensated for supplying their sales training materials to mutual fund retailers through reciprocal brokerage business and give-ups on mutual fund portfolio transactions,[64] are Kalb, Voorhis & Co., and Arthur Wiesenberger & Co. Kalb, Voorhis prepares, among other training and sales aids, a study course entitled Curriculum for Mutual Fund Representatives (CMFR) which is in widespread use throughout the industry. The course consists of 32 small booklets (30 chapters) of which the first 18 contain material covered in the NASD examination, and the balance relate to prospecting and selling meth-

[64] See the discussion of reciprocal business in pt. C, below, and chs. VI.I, VIII.D, and VIII.E.5.

ods. Firms using the CMFR course as a basic part of their training program include Waddell & Reed, Associated Fund, Inc., Mutual Fund Associates (of California), and Financial Programs, Inc., while other firms such as King Merritt & Co. and Heritage Securities make the course available for training purposes upon request of the trainees' supervisors. Arthur Wiesenberger & Co. prepares a "Contractual Plan Service" consisting of a large looseleaf book with chapters to train contractual plan salesmen in prospecting, telephone calls, presentation, and closing. King Merritt & Co. uses this course for training its salesmen after they have taken the NASD examination.

Few firms follow the example of FIC in preparing their own examinations for trainees. Most testing of sales trainees is confined to reviewing sample questions from the NASD and applicable State examinations. King Merritt & Co., however, administers an examination to all of its salesmen which is based upon a question-and-answer booklet issued by the Securities Division of the State of Minnesota as suggested basic information for incorporation in dealers' training programs for representatives selling mutual funds in that State. Two of the large integrated firms which are not members of the NASD, Hamilton and IDS, administer their own examinations to their trainees, but Heritage Securities, Inc., another large nonmember of the NASD, all of whose salesmen are also insurance agents of the associated Nationwide Insurance Cos., requires no examination for its salesmen other than whatever examination may be necessary to qualify them in the States in which they will sell.

The training courses of these large companies which are not members of the NASD, and whose salesmen are not required to pass the association's examination, differ in some respects from the courses offered by the large retailers who are members. Hamilton, which hires over 2,900 salesmen in 1961, most of them inexperienced, offers no classroom training program. It supplies its recruits with a sales manual which contains Hamilton fund and Hamilton contractual plan prospectuses, a booklet on how to make a successful sales presentation together with visual aid materials used in a presentation, and copies of the Securities Act of 1933 and the Investment Company Act of 1940. After home study of these materials for an estimated 40 hours, the trainee takes a written open-book examination prepared by Hamilton and graded in its home office. About 75 percent of Hamilton's trainees pass the exam the first time they take it, and another 15 percent pass on the second try. In addition, according to Anthony R. Tyrone, executive vice president and director of sales, "there are actually people who do not pass it." In a State which requires an examination of salesmen, the recruit's supervisor reviews with him additional materials relating to the State's examination, and if the State gives an NYSE-type examination the recruit is also supplied with a booklet entitled "What is a Corporation." In testimony at the study's public hearings, Tyrone estimated that the average time elapsing between the date a person is recruited as a Hamilton salesman and the time he commences selling is 2 to 2½ months.

Heritage Securities, Inc., one of the other large mutual fund retailers not a member of the NASD, like Hamilton offers no formal training program. Heritage, which recruits all of its salesmen from among insurance agents of Nationwide Insurance Co.'s, supplies

them with a mutual fund reference guide covering an explanation of Government regulations, standards of conduct for securities salesmen, an analysis of its MIF Fund prospectus, and the necessary forms. Apart from passing any required State examinations, the new salesman needs only a certification to his good character and knowledge signed by his supervisor in order to sell.

Whether the training offered recruits to mutual fund selling is formal classroom training, on-the-job training, a combination of both, or purely informal instruction, it is generally brief. The overwhelming majority of mutual fund salesmen without prior experience in the securities business begin selling their merchandise to the public after completing part-time training programs consisting of a few hours a week for a period of 1 to 3 months.

c. Compensation of salesmen

The dominance of commission compensation for salesmen in the securities industry has already been noted in this report.[65] Mutual fund salesmen, like other securities salesmen, are compensated almost exclusively through sales commissions, but their rewards are even more directly tied to production than is the pay of many general securities salesmen. While a considerable number of the latter receive draws against future commissions, only about 3 percent of mutual fund salesmen receive draws, while the other 97 percent are paid on a straight-commission basis.

In view of the high percentage of part-time salesmen in mutual fund sales organizations, it is not surprising that their general level of compensation is lower than the level for general securities salesmen, a major portion of whom are employed full time. The results of the study's STS-1 and STS-2 questionnaires indicate that the annual income of fully 67 percent of all salesmen for firms specializing in mutual funds is less than $1,000; 22 percent earn between $1,000 and $5,000; slightly less than 8 percent earn from $5,000 to $10,000; and 3 percent earn over $10,000 per year.[66] For salesmen employed by nonspecializing firms, the comparable percentages are 13 percent annually earning less than $1,000, 20 percent earning between $1,000 and $5,000, 25 percent earning between $5,000 and $10,000, and 41 percent earning over $10,000 (table XI-3). For all part-time mutual fund salesmen the percentage making less than $1,000 annually is undoubtedly even higher than the STS questionnaires indicate, since the STS results are favorably affected by the inclusion of the large sales forces of Investors Diversified Services, Inc., and Waddell & Reed, Inc., each of which employs a substantial number of full-time salesmen with substantially higher earnings. In Federated Investors, Inc., with 5 full-time and 444 part-time salesmen, nearly 93.7 percent of the sales staff earned less than $1,000 a year, and 5.8 percent earned from $1,000 to $5,000. In Associated Fund, Inc., with 14 full-time and 202 part-time salesmen, 77 percent earned less than $1,000 a year while 18 percent earned from $1,000 to $5,000. The 43 full-time and 402 part-time salesmen of Pennsylvania Funds Corp. fared better, with 48 percent earning less than $1,000 a year and

[65] See ch. III, pp. 253-255 (pt. 1).
[66] Table XI-2. These figures may include the incomes of salesmen who worked for only part of the year. The figures do not distinguish between the incomes of full- and part-time salesmen, but about two-thirds of the salesmen did sell on a part-time basis.

43 percent earning from $1,000 to $5,000. On the other hand, 89.2 percent of the 582 salesmen for North American Planning Corp. earned less than $1,000 in 1961.

As previously noted, few if any trainees of firms specializing in mutual fund sales are paid while in training. Apart from Investors Diversified Services, Inc., the study found no firm paying compensation of any kind to salesmen during training other than straight commissions, which of course can be paid only after the initial training period is completed and the trainee has qualified to sell securities.

The commissions paid to fund salesmen, as already indicated, represent a share of that portion of the total sales load which is received by the dealer, or a share of the total load retained by the principal underwriter, if it maintains its own retail sales organization. The size of the salesman's share depends on his monthly, annual, or cumulative production. Customarily, a beginning salesman receives about 40 percent of the dealer discount and the percentage increases as his sales reach specified levels. Typically the maximum sales commission ranges from 60 to 65 percent of the total sales load, but in some instances it may amount to as much as 94 percent.

Though salesmen's commission schedules vary from firm to firm in a number of particulars, the schedule of Investors Planning Corp. of America (IPC) may be taken as reasonably representative of the industry pattern IPC salesmen, called "investment solicitors," are classified in four categories. The first classification of a new salesman is "basic." After making sales totaling $125,000, generally including the full face amount of IPC-sponsored contractual plans sold, he is automatically raised to "advanced" status. After making additional sales of $175,000, or total sales of $300,000, he is automatically promoted to "senior" status. Sales totaling $625,000 represented by at least 100 separate sales result in automatic elevation to the status of "career senior." The commissions within each category vary according to the merchandise sold, as follows:

TABLE XI–b.—*IPC salesmen's commissions*[1] *for categories of salesmen*

[In percent]

Category	On face amount of IPC sponsored		On shares of Fund of America and General Investors Trust[2]	On shares of other mutual funds
	Contractual plans	Single payment plans		
Basic	2.82	3.25	3.60	3.00
Advanced	3.02	3.50	3.90	3.25
Senior	3.22	3.70	4.20	3.50
Career senior	3.32	4.10	4.56	3.80

[1] The firm's share of the sales load ranges, depending upon the investment company securities sold, from 6 percent to the maximum of 8 percent (on IPC contractual plans) of the offering price.
[2] IPC is principal underwriter for both Fund of America, Inc., and General Investors Trust; an IPC subsidiary is investment adviser to Fund of America, Inc.; and IPC has an interest in the investment advisory fee of General Investors Trust. See sec. 1.b.

If a salesman earns a "bonus" by sales of systematic investment plans calling for monthly payments of $150 a month or by cash sales totaling $10,000 or more in a month, the percentages are slightly increased.

Salesmen's commissions on IPC contractual plans, it should be noted, are payable only when installments on the plans are paid, but

each salesman has a vested right to receive his share of commissions on the first 12 installments so long as they do not become delinquent, regardless of termination of his Investor Solicitor Agreement with IPC, and he may also be entitled to receive his share of commissions on subsequent installments of which there is timely payment unless his agreement with IPC is terminated for cause. In this respect the IPC sales representative's contract departs from the provision more common in such agreements under which salesmen are not generally entitled to commissions paid by their customers when they are no longer employed by the sales organization.

The IPC commission schedule also illustrates another extremely significant aspect of salesmen's compensation in the area of sales of contractual plans. A salesman in the "basic" category who sells a $3,000 IPC Systematic Investment Plan providing for monthly payments of $20 over 12½ years, for example, is entitled to receive a total commission at the rate of only 2.82 percent, or $84.60, if the purchaser completes all his payments. However, he receives $57 of his total commission out of the first 12 payments,[67] and only $27.60 over the balance of the time it may take the purchaser to complete his scheduled payments, assuming he does so. By comparison, when a "basic" investment solicitor sells a $1,000 IPC Single Payment Investment Plan, on which the purchaser makes an immediate payment equal to more than four times the amount paid into a $3,000 systematic investment plan in the first 12 payments, he receives a commission of only $32.50. Such a schedule therefore provides an obvious economic incentive to the salesman to encourage the purchase of a contractual plan with prepayments, rather than investment of the money available for prepayments in a single-payment plan or other form of lump-sum purchase.

Since the provisions of the Investment Company Act relating to contractual plans permit the deduction as a sales load of up to 50 percent of the first 12 monthly payments or their equivalent,[68] whenever paid, it can be said that an economic incentive for salesmen to encourage purchasers to use accumulated funds for prepayments rather than for outright purchases of fund shares is the result of the present statutory structure. It should be noted, however, that some commission schedules further increase the incentive to obtain prepayments by paying salesmen a larger share of the commission on the first 12 installments than on later installments. Thus some firms which pay their salesmen 40 to 65 percent of their dealer's discount on the first 12 installments pay only 30 to 35 percent on subsequent installments. Hamilton Management Corp. also encourages the practice of obtaining initial prepayments by offering salesmen a bonus of an extra 4 percent of each prepaid installment on a contractual plan which is subject to the front-end load. Encouragement of prepayment of installments is limited to those first 12 or 13 which are subject to the front-end load, however, since further prepaid installments would be invested at a sales charge lower than the charge on outright purchases. Thus a Hamilton fund plan purchaser pays sales charge of approximately 50 percent of his first 12 installments, but only about 4.6 percent of subsequent installments, while he would pay 8.5 percent on outright

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[67] These figures include a monthly bonus of $3.00 for selling plans involving payments of $150 or more a month.

[68] Investment Company Act, sec. 27(a)(2).

purchases of Hamilton fund shares. To obtain maximum benefit from this commission structure, Hamilton supplies each of its salesmen with a "Combimatic Program Planner" with which they can suggest to any prospective customer with accumulated funds which part of the funds should be invested as prepaid installments on the purchase price and which portion should be used for an outright purchase of shares. Hamilton forbids its salesmen to give the "Planner" to their customers.

Salesmen's commission schedules, besides providing inducements for salesmen to sell contractual plans and collect prepayments, may encourage the recommendation and sale of certain funds in preference to others, in a manner which often is not clearly disclosed to a prospective purchaser even in the prospectus. The IPC prospectus discloses that IPC is the principal distributor of shares for Fund of America, Inc. and General Investors Trust, but a purchaser of shares of either of them might not be aware that the salesman recommending them receives a larger commission on their purchase than on the purchase of shares of some other fund. Similarly, a purchaser reading the prospectus of funds affiliated with the Channing complex would not learn that King Merritt & Co., Inc., whose salesmen distribute shares of these funds, pays its salesmen a commission of 58.33 percent of the dealer's discount plus an 8.33 percent contribution to the King Merritt Profit-Sharing Plan on sales of Channing funds, but pays only 50 percent of the dealer discount on sales of shares of other funds.

Similarly, sales contests which often are conducted by mutual fund sales organizations usually reward sales of one or several specified funds. The prizes, in the form of cash, merchandise (including luxury automobiles) and expense-paid vacation trips to well-known resorts or to Europe, are likely to color salesmen's recommendations. The extra compensation, whether or not used to reward the sale of a limited number of funds, may also serve to encourage hard selling, although one industry representative has asserted that sales contests merely serve to stimulate salesmen to make more prospecting calls and presentations than they ordinarily would.

An element of the compensation of mutual fund salesmen of firms doing a general securities business which may influence their recommendations of funds is related to the reciprocal business practices discussed in detail later in this chapter.[69] Here it is sufficient to note that certain broker-dealers pass on to the individual salesmen responsible for the sale of particular mutual funds a portion of the reciprocal commissions the firm receives in connection with portfolio transactions of such funds. While the fund prospectuses disclose the fact that funds pay additional compensation to broker-dealers by means of reciprocal business, they do not indicate which broker-dealers receive such payments or whether they pay over a portion to individuals responsible for selling the funds.

4. SALES TECHNIQUES

The sale of mutual fund shares and contractual plans is accomplished by those who specialize in their sale through three distinct

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[69] See pt. C, below.

steps known in the lexicon of the mutual fund retailers, as "prospecting," "the presentation," and "the close." For each step the sales organizations have developed a number of apparently successful techniques which are passed on to trainees and salesmen in training courses, sales manuals, company publications, and meetings. The techniques may vary from retailer to retailer and are subject to improvisations as infinite as the ingenuity of individual salesmen, but certain common themes and practices recur.

a. Prospecting

"Prospecting" is the term commonly used in merchandising to describe the procedure of developing lists of names of prospective customers. While salesmen of most securities firms are expected to seek out or "prospect" for new customers,[70] the practice is of particular importance to the mutual fund salesman, who cannot reasonably expect commission income from a turnover of his customer's portfolio and must constantly make sales to new customers.

All sales training programs emphasize the importance of prospecting. "At first prospecting may seem like drudgery, but it pays off in interviews and interviews mean sales," says a Renyx, Field & Co., Inc. manual. Hugh L. Jamieson, president of King Merritt, attributing the heavy turnover in his firm's salesmen to the failure of many new salesmen to make enough money selling securities, testified:

> Usually they just won't make the calls necessary to accomplish the job.

The training course prepared by Wiesenberger & Co. reminds trainees that, "The true inventory of a salesman is People," and adds:

> The Contractual Salesman is fortunate to be a mass merchandiser. Eight out of ten employed people are his prospects. This means he can achieve maximum product exposure in minimum time, the ultimate selling efficiency, IF he prospects systematically and steadily. [Emphasis in original.]

The first source of prospects for a new recruit is the circle of his personal acquaintances: his relatives, friends, neighbors, and business acquaintances. Training courses generally provide memory aids designed to assist the new salesmen in preparing a list of 100 to 200 names, such as the "memory jogger" of Renyx, Field [71] consisting of 100 questions such as:

> Whom do you know from your old job?
> Whom do you know from your church?
> Whom do you know through your children?
> Who sells you your groceries?
> Who is your dentist?
> Who is your best luncheon club friend?
> Who heads the local parent-teacher association?
> Who is your florist?
> Who is your postmaster or letter carrier?
> Who soles your shoes?
> Who heads your bank?
> Who lives next door to you?

Even before a new salesman approaches his friends, relations and acquaintances, however, he is told that he should himself be con-

[70] See ch. III, pp. 250–253 (pt. 1).
[71] The use of the "memory jogger" in Renyx, Field's training program is discussed in ch. II, p. 110 (pt. 1).

vinced of the need for accumulating equity investments through a contractual plan. As the Wiesenberger sales training manual puts it:

> Naturally, your *first* sale should be to *yourself.* By now you should know *you* need one. To you as a Salesman, however, the benefits are doubled. Nothing makes your Sales Presentation more effective than illustrating how a Contractual Plan works *with your own Plan!* Bring out your Plan Certificate, your receipt and reminder notices, and tell the Prospect why *you* are proud to have this Plan. Proof of the pudding is in the eating. The Salesman who owns a Plan has *concrete* evidence of his faith in contractuals. [Emphasis in original.]

To encourage purchases by their own salesmen some firms which are affiliated with the investment adviser or principal underwriter of the investment company, remit up to 94 percent of the dealer's discount on contractual plans purchased by salesmen, thereby substantially diminishing the impact and stimulus to saving of the front-end load. For the sponsors which do not remit a portion of the sales charge to their salesmen, the purchases by new salesmen of plans for themselves may represent a substantial amount of sales revenue, in view of their heavy recruiting efforts.

Mutual fund training courses attempt to overcome the embarrassment which a new salesman may feel in approaching his friends by instilling in him pride in the merchandise he is selling. Again the Wiesenberger manual states:

> Do you believe in your Product? If you do, you should offer your family and friends first chance to take advantage of it. Of course, it's easier for you to approach them. But that's not the point. If you have the professional pride in what a Contractual Plan can do for people, you MUST, out of friendship, help your friends help themselves through Contractuals. If you feel shy about selling to your family and friends, go back and study our product: if you aren't proud of it, you don't know it, and if you don't know it, you aren't ready to sell to anyone.
>
> Suppose, at the beach, you see two men drowning. One is a close friend. Do you help the stranger first * * * or your friend?
>
> Financially, a Contractual Plan may well be a lifeguard to a man without capital. If friendship and kinship mean anything to you, act accordingly.
>
> How will you feel, five years hence, after selling to thousands of strangers, if one of your close friends fails to achieve an important Goal in his life because he lacks the money * * * which you could have helped him acquire if you had sold him a Contractual today? Just because a man is a friend or relative is no reason why you should leave him out in the cold. Tell him so. He will be the first to understand. [Emphasis in original.]

The effectiveness of the prospecting approach to personal acquaintances is demonstrated by the results of the Mutual Fund Investor Survey discussed below.[72] The survey noted that purchases from salesmen's relatives and close friends accounted for 35 percent of contractual plan sales and 20 percent of regular account sales among those sampled.

To the salesman who has commenced selling, a large new field of prospects is opened through referrals. Every salesman is taught to ask each person to whom he makes a sale for the names of a definite number—two, three, or five—new prospects. The limited number of names requested makes it easy for the purchaser to comply with the request. A refinement of the referral technique is the "radiation card" which, signed by the purchaser, serves to introduce the salesman to the prospect the purchaser has provided. One firm has estimated that as many as 60 percent of its prospects come through signed radiation cards.

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[72] See sec. 5, below.

"Radiation" is also used in mutual fund selling to describe the process of cultivating the acquaintance of persons to whom sales have been made in order to obtain additional referrals of prospects which have not been expressly solicited. Largely the techniques of radiation involve a followup of the sale and the purchaser. Salesmen are advised to write congratulating a new customer on his purchase, to call him when he receives his plan certificate, to call him when the fund issues its annual and semi-annual reports and when it declares dividends, to send him personal birthday cards and notes of congratulation or condolence. The continuing relationship often results in a continuing source of new business.

Mutual fund salesmen, like other securities salesmen, also make use in their prospecting of mailings, telephone calls, and the "cold-turkey" call. Mailings by fund salesmen are generally selective, since their cost is borne by the salesman himself, and are made to persons whose names are obtained from street directories, classified telephone directories, or newspaper accounts of promotions, appointments, engagements and weddings, births, and probate notices. Mailings frequently consist of materials prepared or obtained for the salesmen by the mutual fund retailer, and may have a perforated section to be torn off and returned by the recipient who is interested in an appointment. However, salesmen are usually counseled:

> Within 1 or 2 days after the prospects must have received the mailing, call them on the telephone * * * Don't wait for them to call you.

Telephone calls, whether used as a followup to a mailing or without such preparation, are principally used for making appointments, not for making sales themselves. Cold-turkey calls, while not recommended in training courses as an exclusive means of prospecting, are suggested as a means of filling in gaps in appointment schedules. Small businessmen at their place of business are recommended as the best prospects for cold-turkey calls, because salesmen call on them regularly.

Other prospects are obtained by fund salesmen through advertisements or other promotional devices used by the retailers for whom they sell. The King Merritt organization establishes booths at county fairs and displays signs inviting passersby to "Win a share of a mutual fund" by guessing what $10,000 invested in its growth fund at a given time would be worth 10½ years later. According to the King Merritt house publication, the annual exhibits represent "an excellent way to obtain leads and advertise our services at a low cost." Other fund retailers maintain booths at places such as railroad stations and discount supermarkets to distribute sales literature and obtain leads. The principal underwriter of one group of funds utilized a bride's suggestion book distributed by department stores which, in addition to recommending certain brand names in household appliances, urged the young couple to initiate an investment program and "consult a qualified investment dealer or broker and ask him about the Axe Funds."

It appears to be a common element of prospecting techniques to avoid an initial disclosure of the fact that the salesman is selling mutual fund shares or contractual plans. In telephoning prospects for appointments, salesmen are often told to refer to themselves as financial

planners, and a typical telephone opening suggested by the Wiesenberger sales training manual says:

> Mr. Smith, we have just developed a New Financial Plan for executives of your type. I know that you will be interested. Would you rather make it an appointment tomorrow at 10:30 in the morning, or would Wednesday afternoon at 3 be better?

In similar vein are a mailing piece and telephone script used jointly by salesmen for People's Planning Corp. of America of New York City. The mailing piece advertises:

> A FREE SERVICE
>
> *that can be vitally important to you*
>
> At your request we will be happy to get *an official report on the current status of your own Social Security account.*
>
> * * * * * * *
>
> Not only is it important to you that you know where you stand but the report enables you to catch any errors in your record. *There is a time limit on the correction of errors.* Our experience in working with people with their financial problems has shown the need for keeping yourself up-to-date on this information. [Emphasis in original.]
>
> Since the social security reports can only be obtained at the request of the prospect, the salesman calls the prospect who has indicated interest to explain that it is necessary for the prospect to complete a form, and to make an appointment to bring the form to him. The following suggested answers to possible objections are distributed to the salesmen.
>
> Q. What are you selling?
>
> A. Mr. Prospect, my organization specializes in financial planning. We've helped many families to understand Social Security, its benefits and requirements. We are happy to provide this important service without cost or obligation.
>
> Would Tuesday at 8:15 be a good time for me to bring you the form I mentioned, or would Thursday at 8:45 be more convenient?
>
> Q. You can't be doing this for nothing. How are you taken care of?
>
> A. Mr. Prospect, we are compensated only in the event that we assist you with your personal financial planning. However, we are happy to provide important information regarding Social Security, its benefits and requirements without any cost or obligation on your part.
>
> Would Tuesday at 8:15 be a good time for me to bring you the form I mentioned, or would Thursday at 8:45 be more convenient?

The first point at which the prospect may learn that the "financial planning" specialist is a mutual fund salesman is when, after the prospect has filled out the form, the salesman suggests that social security at retirement is a hedge against falling prices but that he can show the prospect how to hedge against rising prices.

Another illustration of the approach of delayed disclosure is illustrated in the Kalb, Voorhis monthly subscription service, Modern Securities Services, under the title "Ideas for New Salesmen":

> Many new salesmen are reluctant to call on friends and relatives—and even if they are willing to do so, they feel a little foolish trying out their presentation on someone they know so well.
>
> Some salesmen turn this reluctance into an advantage. They call their old friends, ex-colleagues from past jobs, relatives, and others they know well, and they say they need some advice. Usually it's easy to arrange an appointment on that basis.
>
> When they keep the appointment they explain that they have a presentation they want to try out * * * would the friend just pretend he was a prospect, ask all the questions that would normally occur to him if he were, and listen on that basis?
>
> The entire presentation should be made with the friends' needs in mind * * * slanted to college education, retirement, whatever fits best.

The salesman then makes the complete presentation and at the end, may switch with something like * * * "The more I think of it, George, the more I think *you* really ought to invest in Mutual Funds. I know you'll retire in about — years, and it's time you started to do something about it."

The salesman can then switch to the personal completely, and go for the close.

If he makes the sale, fine. If not, he will at least get some advice on his presentation, as well as some practice in giving it, and he stands a good chance of getting referrals. [Emphasis in original.]

The type of prospecting represented by these examples is defended by industry representatives on the grounds of necessity, so long as the presentation is complete and honest. Questioned in the study's public hearings about the "Ideas for New Salesmen" quoted above, Ferdinand Nauheim, the Kalb, Voorhis partner responsible for the preparation of its mutual fund sales and training materials, answered:

As far as the high standards of what a salesman is taught to do in selling mutual funds, the crucial area is the presentation itself. How he gets someone to listen to him is a different subject because a salesman who becomes imbued with the need for most people to do something to plan for their financial future recognizes the fact that he has to find ways and means to get people to listen to that story * * *. So I think it is well in keeping with the high standards of this business, if a man is sincere about wanting to reach people, with a story that needs to be told, if he does things that may sound to you as though they are tricky, but we who are daily engaged in this business of trying to help people recognize a need, if we are going to get people to hear something that can do them good.

Similarly in discussing the use of the term "professionalism" in connection with the sale of mutual funds, Hugh L. Jamieson, president of King Merritt, testified at the study's public hearings:

I think the way one prospects is unimportant in * * * professionalism. It is his attitude in presenting the case and carrying out the objectives * * * where professionalism comes in.

b. The presentation

The objective of all prospecting is an appointment with the prospect, which usually takes place at his home or office. Although mutual fund share purchases are sometimes made on an outright basis without a personal meeting between the purchaser and the salesman, these purchases are more often the outcome of such meetings, and virtually all contractual plan sales result from one or more personal contracts.[73] At the appointment the salesman has the opportunity to make his sales presentation, and, if possible, close the sale. The sales presentations recommended by various retail organizations differ in many particulars. In some firms the salesman is expected to commit the entire presentation to memory, while others permit greater latitude. In almost all presentations of salesmen of all companies, however, there are certain consistently recurrent sales approaches.

The mutual fund salesman is taught that after he has paid the recommended compliment to the prospect on his home, office, or children's pictures ("There's *always something* admirable about Mr. Prospect's office or his house" [emphasis in original]), his first statement will set the atmosphere for his whole presentation. His opening statement, it is therefore suggested, should challenge the prospect

[73] In the Wharton School Survey, approximately 25 percent of regular account purchasers reported no meetings with salesmen but virtually all contractual plan buyers reported that such meetings did occur. See sec. 5, below.

and arouse his interest. As stated in the Kalb, Voorhis CMFR training course:

> Clearly, you are not going to accomplish this objective if you approach people and say: "I want to talk to you about Mutual Funds * * *" "I want to talk to you about investments * * *" "I want to talk to you about the things you want to do for your financial future." These are generalities. They are vague. They show little or nothing to the average individual. What they actually say to most people is "This is a salesman who tells me he's got something in the investment field he wants to sell me."
>
> *   *   *   *   *   *   *
>
> If the first things you say *promise a benefit* the individual can appreciate and understand * * * if the first words you say *shock* into full attention * * * if the first words you say are so *challenging* that they cannot wonder but what comes next, then you have started out on the right foot. If they fail to measure up to any of these descriptions, you have a difficult job on your hands. [Emphasis in original.]

The promise of a benefit on occasion raises questions of the possibility of its fulfillment. The Kalb, Voorhis CMFR course sets forth the following example of an effective attention-getting opening:

> You are in a repair garage. A young mechanic is working on your car. You and he are talking while he works. You ask, "Do you own this garage?"
>
> "Oh, no," he says, "Old Mr. So-and-so owns this garage."
>
> "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 $50,000?"
>
> The tools drop, the young man stands up. You have his complete attention.

A recommended keynote in the Wiesenberger training manual suggests a similar, though more modest, benefit.

> Mr. Prospect, if I can show you $10,000 you never knew you had, will you let me tell you how we can put it to work for you?

The opening stages of the interview are not, the salesman is told, the time to disclose that he is selling mutual fund shares. In the words of the King Merritt house publication, "The Golden Horse":

> In the approach, one of the most important things to remember and one of the most difficult things to do is not to disclose the complete nature of your business. Once you mention mutual funds and describe them, there is no need for your prospect to see you.

The next step of the presentation, once the salesman has his customer's attention, is to awaken the prospect to his needs and goals, or to offer him "financial planning." Again to quote from the Kalb, Voorhis CMFR course's advice to trainees:

> You are a doctor of income * * * a doctor of future financial health. You can't hand out a prescription before making an intelligent diagnosis.
>
> *   *   *   *   *   *   *
>
> In most cases you will be attempting to get down a portrayal of what that person has to look forward to in the years ahead * * * a diagram of his financial needs when the day of retirement arrives * * * a picture of what continuing inflation may do to his dollar needs when that day comes. These are facts and figures that the average prospect has never thought about or looked at before. They can be tremendously frightening to him. This is your job * * * to instill well-justified fear of the future.

While mutual fund salesmen frequently describe themselves as financial planners, the financial program which they offer is, on its most elementary level, a suggestion that customers allocate portions of their savings and income to equity investment in mutual funds. Financial

planning as conceived by fund retailers involves apportioning part of their customer's resources among insurance, emergency funds, and mutual fund shares. Training courses typically note the importance of life insurance and emergency funds in financial planning. For example, the CMFR course, stating that there is no easy answer to "how much insurance," concludes:

> Since no one can give an exact formula as to how much insurance a person should carry nor how much he should invest, the logical approach is to explain to a prospect just what alternative courses of action he can take with the money he has available. The prospect himself must make the choice.

As to emergency funds such as ready cash, savings accounts, and U.S. Treasury bonds, the course concludes:

> Opinions differ as to the amount needed in an emergency fund * * *. The general average seems to be the equivalent of 6-months' take-home pay. * * *

In planning retirement, the course suggests that anyone who does not have pension coverage (social security benefits at retirement or any other form of fixed pension, including insurance annuities) the projected income from which will approximate half of present income should be encouraged to take action in this direction. It continues:

> If half of present income is to be provided on retirement from fixed-dollar investments or pensions, then the other half should come from variable dollars. * * * Naturally, you will recommend the accumulation of Mutual Fund shares to provide this type of income at retirement.

From a number of scripts of sales presentations approved for salesmen's use by retailers which were reviewed by the Special Study, it would appear that the insurance and emergency fund elements of financial planning receive more attention in training courses than in actual presentation. Waddell & Reed, Inc., which uses the CMFR course for training salesmen, suggests two approved presentations for new salesmen in its manual for managers, one as a presentation for the sale of voluntary accumulation plans and the other for selling contractual plans. Neither makes any mention of the need for adequate life insurance or emergency funds. Proposed presentations used by salesmen for First Investors Corp., King Merritt, and Hamilton similarly omit mention of the need for such assests. At Renyx, Field, whose salesmen are required to commit a presentation to memory, the entire consideration given emergency funds and insurance is contained in the following passage:

> *Mr. Prospect, are you planning for tomorrow?* As you well know everyone needs a well balanced financial program. There are three kinds of money necessary for such a program.
>
> *The First* is adequate cash for emergencies. This could be a checking account, savings account, Government Bonds. *The Second* kind of money is adequate life insurance and after these requirements are . . . *The Third* kind of money "Working Dollars" to build a living estate. Mr. *Prospect, how much of that third kind of money have you and Mrs. Prospect been able to set aside for yourself so far?* [Emphasis in original.]

The three financial needs to which mutual fund salesmen most commonly direct their prospects' attention are retirement, the college education of children, and the creation of an estate for a wife.[74] When the

[74] The Mutual Fund Investor Survey showed that while most investors purchased mutual fund shares without specific objectives in mind, the most important specific target was provision for retirement, followed by the accumulation of an estate and the financing of children's college education, with a higher proportion of contractual plan purchasers planning to finance education. See sec. 5, below.

goals are determined, the salesmen are instructed to translate them into dollars. Hamilton for example, has a visual aid which sets out the costs for 4 years of college at various colleges. For a retirement figure, the CMFR course suggests that the salesman ask the prospect for an estimate of his necessary weekly retirement income and multiply it by 1,300. (The salesman is told that the multiplier gives the amount of capital needed at 4 percent interest to produce the income wanted, but is warned not to mention the rate of return to the prospect since he may violate the Statement of Policy by implying that such return may be realized on the fund shares he is selling.) Using the example of a $200 weekly income, the course arrives at a sum of $260,000, and states:

> This you write on the paper boldly and circle it. It's a mighty important figure. It's a shocking and startling figure to most of the people you talk to. * * * It is a good thing to let the fear of this figure grow. You are firmly planting that strong feeling of urgency that we recognize as so essential to a successful Mutual Fund sale.

With the prospect's goals determined, the salesman in the usual presentation will proceed to demonstrate, with appropriate references to visual charts and tables in the prospectus, that an investment in the mutual fund whose shares or contractual plan he is selling may help achieve the goal. Compliance with the Statement of Policy precludes predictions of future performance, and the careful fund salesman explains this. However, the Statement of Policy permits a review of past performance of the fund, so long as the salesman warns the prospect he is talking of the past and a period of generally rising market prices. The salesman therefore establishes on the basis of past experience the results which a man in his prospect's position might have achieved had he invested at a particular time in the past. The Statement of Policy also permits comparisons of fund performance with investments in savings banks or Government bonds so long as the salesman neither represents nor implies that mutual fund shares are similar to or as safe as such investments. The salesman therefore may compare the amounts which a customer would have had by investing, say, $10,000 in a particular fund 15 years previously and reinvesting all dividends and capital gains with the amount he would have realized by the investment of such a sum in a savings bank or Government bonds over the same period. He follows the comparison with a statement such as:

> Of course, results in a Government bond are guaranteed, the principal in a savings bank are [sic] also guaranteed, results in Wellington Fund are not guaranteed and cannot be predicted in advance because its value fluctuates, and the dividends vary in amounts. However, in the past 15 years, in a $10,000 investment, there would have been a difference of over $21,000 between money in the bank and Wellington Fund. In other words, in the past 15 years, if you wanted to guarantee your $10,000, it would have cost you the difference in the results, in this case, over $21,000. Mr. Prospect, wouldn't you say that this is a high price to pay for any guarantee?
>
> There is one thing that banks and bonds cannot guarantee, and that is a hedge against inflation. * * *

In the usual sales presentation, the salesman will also use the fund or contractual plan prospectus to demonstrate the manner in which the fund he is selling provides portfolio diversification and professional management. The CMFR course warns the salesman against the use of the term "diversification":

It is an awfully big word. It's a big word that people who are not acquainted with investments do not fully understand. * * * Instead * * * we should speak in terms *of spreading one's dollar over American industry * * * having ownership in a great part of America's industrial might * * * being a part-owner in the vast number of industries that we see about us every day of our lives.* [Emphasis in original.]

Whether he uses the term or not, the salesman customarily points out to his prospect both the number of companies in which the fund's portfolio is invested and the names of such companies as he believes will be best known to the prospect. There is no question, however, about the desirability from a sales point of view of the phrase "professional investment management," which is generally used as a strong selling point.[75] One company-approved presentation states the advantages in the following manner:

* * * [Y]ou also have day after day supervision by full time Professional Management. This management has people constantly watching over these various investments, and their research staffs and analysts study industries and companies. This means, Mr. Prospect, that you yourself do not have the concern of when to buy certain stocks, how long to keep them, or when to sell them. In Wellington Fund you have the Professional Management who will take these worries off your shoulders.

To illustrate the caliber of this management the salesman may turn to that part of the prospectus which lists the fund's professional investment managers and advisers and read off their names, affiliations, and backgrounds.

Among the attributes of mutual fund investing which may also be included in a sales presentation's listing of advantages is convenience in ownership. This convenience includes the consolidation of a number of dividend checks into a single dividend check, simplification of tax reporting problems (with the fund or plan providing a statement of amounts taxable to the investor as dividends or capital gains), and safekeeping of securities by the fund custodian. The automatic reinvestment of capital gains and dividends is also part of this convenience. For those whose objective is the accumulation of an estate, the salesman may also point out that management is in effect bequeathable, that on the purchaser's death his widow or heirs will continue to have the benefits of diversification and professional management and will need to make no decisions on the handling of securities. Probate problems often are claimed to be simplified through the use of a "designation of beneficiary" form supplied by the salesman.

The use of "designation of beneficiary" forms and other trust forms often supplied to salesmen as a part of their kits is viewed with mixed feelings by the industry. As early as April 1959, the NASD News cautioned dealers on the use of trust forms:

The growing practice by certain dealers—and some underwriters—specializing in the sale of investment company shares of offering customers "free advice" on the establishment of various types of testamentary trusts, "living trusts," and other means of disposition of property can result in the assumption of unnecessary risks by all concerned.

Indiscriminate distribution of various types of self-executing forms of trust and testamentary documents, and the recommendation that they be used by dealers with customers can be dangerous.

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[75] The Mutual Fund Investor Survey revealed that the most frequently encountered reason given by both regular and contractual plan investors for acquiring mutual funds was the desire for professional investment management. See sec. 5, below.

From a legal point of view the execution of a designation of beneficiary form, sometimes denominated a "declaration of trust," creates a simple revocable trust of which the purchaser is grantor and trustee and the mutual fund shares or contractual plan interest is the corpus. While such a trust serves on the death of the purchaser to pass the trust property to the beneficiary, it performs no other function. As stated in the Wiesenberger sales training manual:

> Considering the fact that revocable trusts confer no tax benefits and most often delay rather than hasten the receipt of the trust assets in the event of the grantor's death, their use as a sales gimmick would seem of dubious worth to the client.

Despite the fact that King Merritt uses the Wiesenberger sales training manual, it makes available to its salesmen as a part of their regular sales kit, but with instructions that "an attorney should always be consulted," not only the simplest form of revocable trust but also a form of declaration of revocable trust with discretion as to the distribution of income, a form of declaration of revocable trust with income to the grantor for life and then to his spouse, an irrevocable reversionary trust for distribution of income to an adult beneficiary, a reversionary trust for a minor beneficiary providing for the accumulation and reinvestment of income during minority, and a declaration of trust providing for a secondary beneficiary. Similarly Hugh W. Long & Co., an underwriter selling to independent broker-dealers, distributes a kit entitled "Personal Financial Planning, a Service for Investors and Investment Dealers" which includes five separate forms of trust each bearing at the bottom a legend stating that they are to be used "as a basis for discussion with your attorney." On the other hand, Anthony R. Tyrone, executive vice president and director of sales of Hamilton, asked at the study's public hearings whether his firm provides salesmen with trust forms, replied:

> We have a declaration of trust. It should be eliminated. The reason we have it is competition makes it necessary.

Shortly thereafter Hamilton advised the study that it had decided to withdraw the trust forms from its salesmen's kits.

The dangers created by the use of these forms are not only the possibility that they may be discussed by salesmen whose training has scarcely equipped them to consider their legal complexities and who may fail to observe the instruction to suggest consultation with an attorney,[76] but the possibility that salesmen unskilled in tax matters may use them to suggest illusory tax advantages. In an "Introduction to Estate Planning" distributed by Investors Planning Corp., for example, it is stated that:

> Through the use of the IPC declaration of trust, the individual can pass the IPC investment plan to members of his family with a minimum of shrinkage by taxation.

Walter Benedick, IPC's president, when questioned on the nature of the suggested estate tax advantage in the use of its revocable trust form, indicated that it referred to the marital deduction which the planholder would enjoy on that portion of his estate held in the trust,

[76] The Mutual Fund Investor Survey notes that one-third of the respondents reported that salesmen had initiated discussion of wills and trusts, but that fewer than 20 percent of respondents reported that salesmen advised them to consult an attorney or financial adviser. See sec. 5 and app. A, sec. VII.

an advantage which he conceded could be accomplished to the same extent by will. It is doubtful that an IPC salesman could understand from this pamphlet that the claimed tax advantages were so limited, nor is it likely that he would be competent to advise a prospect on the intricate nature of the marital deduction.

For most mutual fund salesmen, the presentation is also used as an occasion for explaining the sales charges which the purchaser incurs.[77] Indeed, in the sale of a contractual plan, salesmen are taught that the penalty feature of the front-end load is an important sales argument. The Wiesenberger sales training manual, for example, tells salesmen:

HAMMER THE PENALTY HOME!

Any evasion, *any* lack of disclosure, *any* failure to EMPHASIZE the Penalty Feature of the Contractual Plan is poor selling because . . .

The Penalty Feature is the Most Important Sales Feature to the Prospect with Little or No Capital.

"Mr. Prospect, perhaps you wonder why I emphasize this point. Well, we are all human! I know you have kept up mortgage payments on your house with great regularity. Why? Because you don't like living in a tent. On your car? Because you don't like walking! But why not to yourself? Because you had no *immediate* Penalty if you failed to pay yourself.

"Do you know that 90% of the investors who try the Voluntary Plan method of monthly buying without penalty *fail* to carry their Plans through the 5th or 6th year? On the other hand, 90% of Contractual Plan Investors complete their Plans because the Penalty taught them the Habit of Monthly Purchase.[78] [Emphasis in original.]

The presentation suggested by Wiesenberger contains the two principal elements consistently stressed by salesmen in explaining contractual plan sales charges: the resemblance to the purchaser's prior experience in buying a home, an automobile, or other merchandise on an installment basis, and the stimulus of the penalty to developing systematic savings habits.[79] When objections are raised to the sales charge, the Kalb, Voorhis CMFR course suggests the following answer which has been used successfully:

"Let's talk about you and automobiles for a moment, may we? Let's say that I am a very good friend of yours and I'm very well off. * * * I have so much money I don't know what to do with it. And I have a handsome car that costs a lot of money, that you would like to own, and you know that I am thinking of selling it. You say to me, 'Why don't you sell me the car? I can pay you $125 a month for the next 3 years without hurting too much.' I'm perfectly willing and I say, 'Sure, Bill, that's fine with me. But, Bill, we're good friends, and I'm not worried about the money. If you have to miss payments because of sickness in the family or you want a special vacation trip or something, don't worry about it. Pay me when you can.'

"Now, that would be wonderful, wouldn't it, Mr. Record? But, let's look at it a different way. Suppose, instead of coming to me, you went to a banker to

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[77] The Mutual Fund Investor Survey notes that a substantial majority of regular account purchasers reported that the salesman had described the sales charge, that 82 percent of the contractual plan purchasers reported they had been told the proportion of their payments which would constitute sales charges in the first year, and that about two-thirds reported explanations of the sales charge over the life of the contract. It also notes, however, that less than 40 percent of regular account purchasers could give a reasonable estimate of the sales charge they had paid, that only about 40 percent of contractual plan purchasers could give a reasonable estimate of the first year's charge, and that less than 25 percent could estimate the sales charge over the life of the contract. See sec. 5, below.

[78] As noted in sec. 7.h(3) below, the estimate of a 90-percent completion rate on contractual plans is substantially at variance with data known to the study. For a discussion of the extent to which the "penalty" has operated as a successful stimulus in promoting habits of systematic investing among planholders, see sec. 7.g(1), below.

[79] The Mutual Fund Investor Survey notes that almost one-half of contractual plan purchasers responding cited discipline in saving as a chief reason for acquiring this type of investment. See sec. 5, below.

borrow the total amount you needed to buy the car from an agency. He agrees to loan you the money, but he says, 'Mr. Record, a word of caution. Don't miss any payments. This is an obligation you must keep, and if you get 60 days behind you won't have a car and you may still owe us money besides.'

"Mr. Record, quite frankly, which car would you own at the end of the 3 years?"

Some salesmen also find it an effective method of dealing with objections to sales charges to compare the overall charges with the markup on various forms of tangible merchandise. The Wiesenberger sales training manual contains the following suggested reply to an objection:

"You've raised a good point, Mr. Prospect. That sales charge is mighty important to you. It pays me and thousands of other salesmen to bring investors like yourself together in the ownership of this Mutual Fund so that you can afford skilled investment Management. As sales charges go, however, the 8½ percent commission you pay in buying a Mutual Fund is a lot lower than the commission you paid when you bought that ring you're wearing. How much commission did the jeweler charge, Mr. Prospect?"

"I don't know. He didn't tell me."

"That's another point: we are required by law to tell you exactly what commission you pay. Most jewelers don't. Incidentally, their markup usually runs around 50 percent, about six times higher than ours. Insurance, real estate, automobiles * * * you name the product, and you'll find the commission runs two to five times higher percentagewise than the low sales charge in our industry. What you buy is a lot more important than the sales charge. Look what this Fund has done for its shareholders in the last 10 years. Won't you be happy if they do half as well for you in the next 10?"

Another favored answer suggests that the objection relates not to the amount of the front-end load but to the lack of determination of the prospect to achieve his goal. The Renyx, Field training manual suggests the following approach:

I don't blame you, Mr. Prospect. Nobody likes sales charges of any kind. On analysis in this case, however, I wonder if it really is the prepayment feature you are uncertain about or is it your own determination to complete the plan. You see, if you *are* determined to complete the plan, *when* the charges are deducted has no real significance to you. [Emphasis in original.] [80]

In connection with the sale of contractual plans, salesmen are frequently urged to describe the advantages of a mathematical phenomenon known as "dollar-cost-averaging," and to point out that the penalty feature of the front-end load, is, in the words of the Wiesenberger training manual, "the key to successful dollar-cost-averaging." Dollar-cost-averaging is defined in the Kalb, Voorhis CMFR course as an investment formula which—

merely calls for a *fixed number of dollars* to be invested in the selected security *at regular intervals*. The fact that a fixed amount of money is invested at fixed intervals (such as once a month, once a quarter, or once a year) means that *no account is taken of price levels*. To be successful, of course, the person doing this *must* be able to make these regular investments during periods of low price levels * * * if he cannot do this, he is *not* dollar-cost-averaging. The *effect* of dollar-cost-averaging is to insure that *average cost* is less than *average price*. This is a mathematical certainty * * * regardless of whether the market is going up or down * * * because fewer shares are bought at high prices than are bought at low prices. [Emphasis in original.]

Dollar-cost-averaging does not, of course, protect an investor against loss in a declining market, and under the Statement of Policy it is deemed materially misleading to suggest that it can or to discuss

[80] But see table XI–d, at sec. 7.e.1, below.

the principle of dollar-cost-averaging without making clear that a plan purchaser will incur a loss if he discontinues his plan when the market value of his accumulated shares is less than their cost, that he is investing funds in securities subject to market fluctuations, and that he must take into account his financial ability to continue the plan through periods of low price levels.

The successful sales presentation is not confined to the words of the salesman and the prospectus alone. The mutual fund merchandisers recognize the need for engaging the eyes as well as the ears of the prospect, and to assist in this respect they generally supply salemen's kits with some sort of visual aids in addition to prospectuses. A number of such visual aids are prepared and supplied to retail organizations by both Wiesenberger and Kalb, Voorhis.[81] Wiesenberger, for example, among other visual aids, distributes "You and Your Dollars," a point-of-contact sales tool consisting of a standup, flip-type, hard-paged, loose-leaf visual presentation which "tells the mutual fund story" in simple terms. The salesman using it can flip over the pages at appropriate moments as he delivers his oral presentations. Kalb, Voorhis, while also providing point-of-sale flip chart kits, in addition prepares cartoon film slides and phonograph records to assist salesmen in their presentations, which it estimates constitute almost 50 percent of its gross business in sales and training aids.

Typical of the simple and graphic presentation of mutual funds in these film slides and records is a filmstrip entitled "The Lady From Overlook Hill." In a series of color cartoon slides with accompanying music and narrative from a phonograph record, the slides depict the plight of Miss Plummer, a schoolteacher who has reached retirement age without adequate funds for her old age. According to the filmstrip, Miss Plummer's misfortune resulted from her having placed her savings exclusively in "frozen dollars," i.e., Government bonds, savings banks, social security, and a pension plan. A cartoon depicts a "Mr. Frozen Dollars" as the cornerstone of a bank. In contrast, equity investments are depicted by a smiling "Mr. Free Dollars," which, the narrator says, make the investor a part owner of American industry. The commentary states that there is a risk of loss in placing one's savings in free dollars, but adds that there is no guarantee of what frozen dollars may buy.

> Whatever you do with dollars there is a risk of loss. Nobody knows that better than the people who have retired after a lifetime of faith in frozen dollars. They did nothing or nearly nothing with their dollars and lost so much purchasing power that retirement years, instead of being happy and relaxed, are terrible years of heartache and deprivation.

Fund retailers also sometimes supply their salesmen with selling literature in addition to the customary form of prospectus to deliver to purchasers during or after the presentation.[82] Some of the more interesting supplemental material of this nature which came to the attention of the study consisted of material of a general, institutional nature, describing the nature of mutual funds generally, but not naming any specific fund, printed in Spanish, German, Chinese, or Yiddish. Walter Benedick, the president of IPC, whose salesmen distrib-

[81] For a discussion of the payment for such aids and other services through reciprocal business channels, see pt. C, below.

[82] Such supplemental sales material may also be deemed a prospectus under sec. 5(b) of the Securities Act of 1933.

ute this material, and which does not distribute the customary form of prospectus printed in these languages, was asked about the material in the study's public hearings:

> Q. What is the purpose of preparing one of these selling documents relating to mutual funds in Chinese?
> A. There are Chinese people who speak perfect English. * * * Yet when they read something in their own language they feel reassured. That is the purpose of the foreign language pieces.
> Q. Do you sell to any persons who do not speak English so perfectly?
>
> * * * * * * *
>
> A. We would expect in such a rare case for the salesman to translate and explain the prospectus to his client.
>
> * * * * * * *
>
> The PRESIDING OFFICER. * * * I don't understand how you use this in relation to a prospectus.
> The WITNESS. Our salesman will explain to a prospective client, who may be a Chinese. He might work downtown as a clerk in a Chinese bank or in some commercial Chinese enterprise. Our man explains it to him, he understands it, he buys a plan, and our man says, "It might interest you to know that we even have a piece of literature that explains the principle of the fund in your own language." That man is complimented that there is something that has been translated into his language. That is the general use of these pieces.

c. The closing

The ultimate objective of all prospecting and all presentations is, as the Wiesenberger sales training manual states, "The signature on the planbuyer's check." Here, where the salesman's potential commission may become a reality, is the acid test of his ethical standards.

The sales training courses emphasize the salesman's duty not to oversell. The CMFR course, for example, states:

> You are acting as a "professional" when you are strong enough to suggest to a customer that he *reduce* the amount he proposes to buy, or defer the purchase until a later day, when you know that is his best course of action. [Emphasis in original.]

Similarly, the Arthur Wiesenberger & Co. basic training manual notes that:

> If, Mr. Prospect has been thoroughly sold on his Goal, it is probable that his *willingness* will *exceed* his ability. *Always Sell Down.* Nothing will breed more confidence in your own professional integrity than cautioning Mr. Prospect *to contract for a lower monthly payment* if there is any question in your mind (or his) about his ability to maintain the monthly payments through bad times as well as good. [Emphasis in original.]

On the other hand, the salesman's immediate compensation is directly related to the size of the purchase and, in contractual plan sales, to the number of installments he can persuade the prospect to prepay. The Wiesenberger instructor's outline for its training course recommends a request for prepayment of the first year's installments as a closing step:

> Selling a Monthly Plan with the first year down helps your client and helps you—
>
> 1. Clients' money goes to work faster.
> 2. Clients with first year down have bigger stake in success of plan, least likely to lapse.
> 3. Salesman gets first year commission *now.*
>
> Request for first year down [is a] good closing step. Never neglect to ask for it! [Emphasis in original.]

As to the first of these statements, it would appear, on the contrary, that more of the customer's money might go to work in an outright

purchase of fund shares with an 8½ percent load. The validity of the argument addressed to lapses is discussed below.[83] There can be no doubt about the third statement, however. Prepayments do enable the salesman to get his first year's commission in a lump sum. By the same token, his economic incentive to encourage the customer in regular payments during the early stages of the plan is substantially diminished.

The ambivalent attitude of the industry with respect to the closing may be illustrated by the following suggestion, entitled "Accidently-On-Purpose," for which Kalb, Voorhis paid a salesman $25 for publication in the "Case Histories From the Field" section of its monthly publication, Modern Securities Service:

> Fred has a new prospect sold on a systematic investment plan. The presentation is completed, the client is ready to grab the pen and sign up. Just one point remains unsettled. How much will the prospect invest? Fred doesn't look up. He asks no questions and just continues filling in the application.
>
> Solution: "When he comes to the amount to be invested he fills out $250 a month. The prospect usually stops him in a hurry."
>
> "I wasn't planning on that much," he may say, apologetically, "the most I can make would be a hundred dollars a month."
>
> Fred smiles and corrects his mistake.
>
> Results: The client often cuts down the total, but Fred finds that it starts him thinking big. When he might have said $50 a month, now he may make it $100. He will invest the minimum that he has had in mind in any event and frequently he will increase it. Fred uses this accidentally-on-purpose technique regularly. Twice the prospect accepted the $250 figure, once or twice Fred closed out the extra zero and settled for a $25 monthly plan. Either way, Fred comments, the sale is never decreased but it frequently grows.

5. THE MUTUAL FUND PURCHASER

In evaluating the selling practices of the mutual fund industry, the Special Study determined that it would be desirable to examine the activities of mutual fund salesmen from the point of view of their customers. To do so it engaged the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to make an independent survey of mutual fund investors. The Securities Research Unit, in October 1962, conducted a survey of a nationwide sample of investors who had purchased or redeemed mutual fund shares in mid-March and mid-June 1962. The purpose of the survey was to obtain information—

> * * * about the general characteristics, expectations and motivations of mutual fund investors, representations made by mutual fund representatives, and investors' use and understanding of the prospectus.

The investors included one group of investors who had purchased fund shares outright in lump-sum purchases or under a voluntary, level-load accumulation plans, called "regular account" purchasers, and a second group who had purchased front-end load contractual plans.[84] The selection of particular mutual funds and contractual plan sponsors was designed to provide a representative cross-section to the industry by type, size and location of these organizations. The survey involved field interviews with a stratified random sample of 450 purchasers and mail questionnaires sent to random samples of 500 persons who had purchased fund shares or plans and 500 persons

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[83] See sec. 7.g(1), below.
[84] For a definition and discussion of contractual plans, see sec. 7, below.

who had redeemed them. (Almost half of the mail questionnaires were returned in usable form.)

The report, entitled "Survey of Mutual Fund Investors" (the Survey),[85] essentially includes five major parts. The first part, sections II through IV, examines the characteristics of mutual fund purchasers, the amounts and financing of their purchases, their objectives in making the purchases and the influences on their choice of mutual funds. The second part, sections V through IX, discusses the relationship between the purchaser and the salesman. It reviews the nature and extent of the contact between them, the investment advice given by the salesman, the manner in which he described fund shares and fund operations, and the representations he made about possible changes in the market value of the shares. The third part, sections X and XI, examines the purchaser's understanding of the investment he acquired and his expectations as to its performance. The fourth part, sections XII through XIV, sets forth the findings relating to persons who redeemed their shares, their characteristics, their reasons for redeeming, and the results of their experience with fund shares and plans. A final part, section XV, consists of a summary and conclusions.

In discussing the characteristics of mutual fund investors, the Survey states that a "typical" mutual fund purchaser is in his middle-to-late forties, married, with three dependents, a high school education, a job involving specialized skills and providing an annual income between $5,000 and $10,000, and is covered by life insurance of between $10,000 and $15,000. Although most purchasers were buying mutual funds for the first time, the proportion which held other financial assets such as shares of other funds, corporate stock, Government bonds, and savings accounts was greater than for the public at large.

The Survey notes, however, that behind the overall view of the "typical" investor lie significant differences between the groups of regular account investors and contractual plan purchasers. It notes a general tendency for the proportion of contractual plan purchasers to rise as levels of education, income and occupational skills decline. It also observes a contrast in characteristics of regular and contractual plan investors with incomes below $5,000, who constituted about one-fifth of each group of purchasers. A large proportion of regular account purchasers with relatively low incomes were retired men, elderly widows and young, single individuals, while many of the contractual plan purchasers in the same income bracket were heads of families in low-paying jobs, often with their wives contributing to family income. In all income groups the proportion of regular account purchasers who already owned a variety of financial assets was considerably higher than for contractual plan buyers.

According to the Survey, the data "* * * confirm the description of mutual funds as primarily a vehicle for mobilizing the savings flows of small-to-medium-sized investors. More than half of regular account investors made purchases involving less than $1,000. More than half of the contractual plan buyers invested initially less than $100." In the typical contractual plan transaction, two monthly payments were made in advance as required by most plans, but a sub-

[85] The Survey is reprinted in its entirety as app. A to this chapter.

stantial number of purchases reflected prepayment of additional installments. For investors as a whole, their purchases involved a relatively modest commitment in terms of their annual income, but the ratio of the commitment to their annual income was high among contractual plan purchasers with incomes of less than $5,000. For more than half of this group the ratio was over 10 percent, and for more than one-third it was above 12 percent, a substantial financial commitment by conventional standards. The principal sources of funds for mutual fund purchases were current income and withdrawals from savings accounts. Almost all contractual plan purchasers relied on these sources for their initial payment, and virtually all planholders expected to make future payments out of current income.

The Survey states that most investors said they purchased mutual funds without specific objectives in mind. Where specific objectives were named, the one most frequently cited was provision for retirement, with the accumulation of an estate and the financing of children's college education next most frequently mentioned. Regular account purchasers and contractual plan purchasers differed little in their objectives, although a greater proportion of contractual plan purchasers planned on their investments to finance children's college education. The choice of mutual fund shares or contractual plans as a medium of investment was most often prompted by a desire for professional management, followed by a desire for portfolio diversification. A desire for capital gains was also of considerable but lesser importance. Almost half of the contractual plan purchasers cited discipline in savings as a chief reason for choosing that type of investment.

In discussing the nature of the relationship between mutual fund investors and salesmen, the Survey points out that sales representatives could influence the investor both in the initiation of a decision to buy mutual funds and in the choice of a particular fund. Salesmen appear to have been more important in influencing the investment decisions of contractual plan buyers than in decisions of regular account purchasers. Sales representatives were reported to have initiated half the contractual plan transactions, and in one-third of the cases they were the single most important influence in the choice of the particular fund. Two-thirds of the contractual plan sales to purchasers in the lowest income group were reported as initiated by salesmen. It would appear that there was a somewhat greater tendency on the part of regular account purchasers both to initiate the purchase of shares and to select the funds in which they desired to invest. Similarly, contractual plan buyers appeared to rely on the advice of friends and relatives to a greater extent than regular account purchasers. In a number of cases close personal relationships between salesmen and purchasers had a bearing on the sales of mutual funds. About a fifth of the regular account and one-third of the contractual plan transactions apparently were handled by sales representatives who were friends or relatives of the purchasers.

In reporting on contracts between investors and salesmen, the Survey notes that a substantial fraction of regular account purchasers reported no meetings with sales representatives, while virtually all contractual plan purchasers reported that such meetings occurred and that a large majority of them took place in the home or place of busi-

ness of the purchaser. Investors meeting directly with sales representatives had an average of three meetings: the average time spent in the meetings by regular account purchasers was between 1 and 2 hours, while it was approximately twice as great for purchasers of contractual plans. Sales representatives working for firms specializing in mutual funds seemed to make a greater selling effort than did those salesmen employed by firms engaged in a general securities business. In discussing the contacts between salesmen and investors, the Survey states:

> Surprisingly, 20 percent of regular account and 10 percent of contractual plan purchasers reported that they did not receive the fund's prospectus.

In reporting a broad impression of the extent to which sales representatives provide investment advice, the Survey notes that in 60 percent or more of the cases the sales representative made no inquiries about the income, financial assets and financial obligations of the purchaser, despite the NASD suitability rule.[86] However, between 80 and 90 percent of all purchasers who met with salesmen reported that the salesman had raised one or more of such topics as tax treatment of payments from funds, general income tax problems, quality of investments, taxes on investors' estates, and problems relating to wills and trusts. Fewer than 20 percent of respondents said that the salesman had suggested they consult an attorney or financial adviser. Respondents indicated that salesmen, in comparing funds, had often commented broadly on the suitability of a particular fund to the investor's needs and referred to investment objectives of different funds, but gave negligible attention to such topics as comparative sales charges, comparative expenses or comparative performance.

Investors covered by the Survey were asked to indicate in general terms the manner in which the funds and their operations had been described by salesmen. As reported in the Survey:

> The overall image which emerges about investors' conception of mutual funds as derived from sales representations seems to be as follows: mutual fund shares are safe, relatively liquid assets which simultaneously provide the benefits of professional management and diversification.

While a large majority of purchasers was apparently told that fund shares could decrease in value, many were told that shares were like savings accounts. Salesmen also indicated that funds were a hedge against inflation, and contractual plan purchasers stated that salesmen had said that plans were a means to encourage savings. A majority of investors reported that salesmen had said that fund shares were registered with the Securities and Exchange Commission, while almost half represented that their management and investment policies were supervised or controlled by the Commission or some other Federal agency. The statements that fund shares are like savings accounts and that fund management and investment policies are supervised or controlled by the Commission both suggest possible violations of the Commission's Statement of Policy on the sale of mutual fund shares. The former assertion apparently had considerable influence on investor decisions, but few explicitly mentioned the latter statement as a factor in their investment decisions. The argument that contractual plans encourage saving apparently impressed a large proportion of contractual plan purchasers.

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[86] NASD Rules of Fair Practice, art. III, sec. 2.

Most investors reported that the salesmen with whom they dealt had explained to them several basic features of mutual fund operations, such as funds' investment objectives and the expenses incurred by funds for investment management and administration. A substantial majority of regular account purchasers said that the salesman had described the sales charges. Eighty-two percent of contractual plan purchasers said that they had been told what proportion of their first year's payments would constitute sales charges, and two-thirds said that the sales charge over the life of the contract had been explained. The modest extent to which the explanations of these basic features were understood or remembered by the investors is discussed in the Survey's section on investor knowledge.[87]

In discussing possible changes in value of fund shares, the majority of salesmen appear to have made fairly conservative representations. More than half the investors in the Survey were told that share prices were equally likely to rise or fall in a year or less while 30 to 40 percent were told that share prices were more likely to rise than to fall in that period. Some salesmen, however, apparently emphasized either a strong chance, or almost a certainty, of a rise in prices within a year. Where the prediction period was longer than a year, salesmen apparently were somewhat less conservative. Only about 30 percent of the investors were told that there was an equal likelihood of a rise or fall in prices and about 45 percent were told that there was a greater likelihood of a rise than a fall. A quarter reported that salesmen had indicated that there was a strong chance of a rise with almost no chance of a fall or that a rise in price was certain. The Survey reports its overall impression—

> that a majority of mutual fund salesmen for both regular and contractual plans exercised restraint in discussing prospective changes in the market values of mutual fund shares with buyers. But this record also discloses much less restraint by some fund salesmen.

In evaluating the knowledge and understanding that mutual fund investors have of their investments, the Survey points out that it is well to bear in mind that guidelines do not exist which would make it possible to compare mutual fund investors with other classes of investors. Taking purchasers of mutual funds as a class by themselves, however, the Survey concludes that it seems clear that mutual fund buyers had only a modest understanding of their investment. They appear to have made some use of the prospectus, since the average time devoted to reading it was a little over an hour for regular account purchasers and a little less than 1½ hours for those who bought contractual plans, but they also appeared to have placed heavy reliance on information from and the recommendations of sales representatives, friends, and relatives, and to use relatively few outside sources of financial information. While purchasers were better informed on sales charges than on other basic elements of their investment security, the Survey noted that for the most part their knowledge was incomplete and often inadequate. About one-eighth of the regular account purchasers in the sample who bought funds with sales charges apparently thought they paid no sales charge and another eighth did not know whether or not they did so. Less than 40 percent were able to provide a reasonable estimate of the sales charge

[87] See app. A, secs. X and XI.

which they had paid. Similarly, 40 percent of contractual plan purchasers could make no estimate of the first year's sales charge; and only about 40 percent were able to make a reasonable estimate (which was taken for the purposes of this study to be 40 to 60 percent of the payments in the first year). Two-thirds of the contractual plan purchasers could make no estimate as to the level of the sales charge over the life of the contract and fewer than 25 percent could provide a reasonable estimate (which was taken to be 5 to 15 percent of the amount of the payments).

Knowledge among fund purchasers in the Survey as to available alternatives likewise appears to have been limited. About 75 percent of regular account purchasers did not know whether there were other funds with higher or lower sales charges, or that no-load funds could be purchased. An even higher percentage of investors in contractual plans were unaware that fund shares could be purchased with sales charges different from those of the plans they bought or that no-load funds were available. Seventy to eighty percent of all purchasers could make no estimate as to fund expenses. Investors' knowledge of the sources of earnings of their funds was somewhat greater than their knowledge of fund expenses, but there was evidence that a considerable number had either a vague impression or a clear misconception of the functions performed by their funds.

The Survey found high investor expectations of future performance of both the stock market in general and of mutual funds relative to the market. More than one-third of regular account purchasers and nearly one-half of contractual plan purchasers who were familiar with the past performance of their funds expected them to do even better over the next 10 years. Fewer than 20 percent of both groups expected them to do less well in the next 10 years than during the past decade. A majority of purchasers of both groups favored further investment in the type of mutual fund security they then held.

In the part of the Survey reporting on persons who redeemed shares or plans, there is evidence confirming the fact that a considerable number of investors acquired fund shares or plans when they had little or no other financial reserves. A substantial proportion (about one-third of regular account investors and two-fifths of contractual planholders) had no savings accounts when they acquired the shares subsequently liquidated after holding them a relatively short time. A substantial portion of persons redeeming contractual plans had annual incomes below $5,000, and there was also a high representation of married men, 40 to 50 years old, who were heads of families with three or four dependents among redeemers of contractual plans. For regular accountholders, the average amount of cash received on liquidation was between $1,000 and $2,000, while for contractual planholders the figure was between $300 and $500. The average interval between purchase and redemption was nearly 6 years for regular account purchasers, but less than 3 years for contractual planholders; over 90 percent of the contractual plans redeemed had not been completed.

After ranking the purposes for which funds were redeemed from the most to least pressing need to obtain cash, the Survey found that the use by contractual planholders of their plans as a source of "rainy-day" savings was clearly evident. Sixty percent of those redeeming contractual plans reported that they used the proceeds for household or