MUTUAL FUND RETAILING: ASPECTS OF MARKET STRUCTURE AND DEALER OPERATIONS

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PREFACE

Of the nearly 5,000 registered broker-dealers as of February 1962, almost half (2,272) described their primary or secondary activity as either the retail of wholesale distribution of mutual fund shares.[1] Mutual fund retailers range in size from Bache & Co., the second largest "wire house" which handles a full range of securities and commodities to the many one-man broker-dealers, some of whom devote only part of their time to fund sales efforts.[2]

Although the half of the broker-dealer community which concentrates its business on fund sales is composed almost entirely of non-member firms, these figures do not reflect the importance of the 677 New York Stock Exchange member firms[3] in the mutual fund retail market because their fund business represents only a small fraction of their overall securities business.[4] On a dollar volume basis however, their share of the retail market is believed to be about one third of total annual fund sales.[5]

The phenomenal growth of fund assets since 1940 may in part be explained by the unique fixed-price structures of the mutual fund market fostered by the Investment Company Act and NASD Rules of Fair Practice.

Chapter One discusses the background and current legal status of this retail price structure as well as the operations of the existing trading market which is not governed by the fixed-price requirements.

Chapter Two deals with certain aspects of fund share distribution, several of which were not described in the Report of the Special Study of the Securities Markets and constitutes in effect, a pilot project in certain heretofore unexplored areas. Attention is focused on the use of mutual fund "selected lists" by retail firms, the relative profitability to such firms of fund shares as compared with listed and OTC stocks and the attempt to identify the costs properly attributable to the several types of securities "merchandise" sold by the retail dealers. This part of our study also explores the various inducements instituted by the funds and the dealers and also reports the dealers' reactions to certain industry problems, including the adequacy of the present range of sales loads and the probable effect on the retail market that would occur if the fixed-price distribution structure were abolished.

CHAPTER ONE: THE REGULATION OF MUTUAL FUND SHARE RETAIL DISTRIBUTION

I. Section 22(d) and the "Bootleg Market" in Mutual Fund Shares

The present mutual fund retail market is uniquely characterized by a fixed-price structure which stems from a combination of statutory provisions, NASD rules and industry custom. The focal point of the regulatory framework is Section 22(d) of the Investment Company Act. Its scope and the NASD rules adopted in its wake can only be understood against a background of the industry market patterns that obtained prior to 1940.

A. Pre-1940 Trading Practices

1. Price Cutting in Fund Share Sales

The basic market for open-end investment company shares was created and maintained by each open-end investment company for its own shares, usually in accordance with provisions set forth in the fund's charter or trust agreement and summarized in its prospectus. Purchases were generally made from dealers who acquired shares from the fund's principal distributor under a selling agreement.[6] The investor was able to sell his shares back to the fund or its principal distributor. The price paid or received for the shares was based on the net assets value of the fund's portfolio to which a sales load was added and in some instances -- a redemption to which a sales load was added and in some instances -- a redemption fee was subtracted in the case of sales.[7] The typical distribution structure consisted of a principal distributor which wholesaled fund shares to dealers under a selling agreement which obligated these "contract" dealers to sell fund shares only at the current offering prices.

For several years prior to 1940, as fund share ownership gained wider public acceptance, brought about in part by the sales efforts of the funds' distribution organizations, an increasing number of dealers entered the fund share market by offering such shares below the prevailing offering prices at which the contract dealers were obligated to sell. The "non-contract" dealers benefited from the selling efforts of the funds' distributors and contract dealers but did not incur their promotional expenses. Because of this competitive advantage and the possibility of engaging in riskless trading enjoyed by dealers not bound by a selling agreement, contract dealers increasingly cancelled their selling agreements and entered the "bootleg market."[8]

2. The Operation of the "Bootleg Market"

The cut-price offering of fund shares was carried on by dealers not bound by selling agreements who made markets in the share of mutual funds without the authority of the funds' principal distributors. Often these non-contract dealers would offer to buy at a little more than the published redemption prices and offer shares for sale at a little less than the published sale price. It has been claimed that this cut-price pattern would have resulted in "... a situation of redemption exceeding sales which would be in the interest of the remaining shareholders."[9] Such a dealer could buy as principal from an investor and either retain the shares for resale to another customer, or could sell the shares to the company or the principal distributor, either for his own or his customer's account. By directly reselling shares to the public the dealer was able to retain the full load as compared to only a part of the load which could be retained if the dealer had a selling agreement with the principal distributor. If the non-contract dealer needed shares to cover a short position, he could usually obtain them from the contract dealers. In an active market such a dealer could get a greater spread than the authorized contract dealer.

In addition to the non-contract dealers making markets in fund shares, some fund distributors and dealers created and maintained markets in the share of the funds which they distributed pursuant to their underwriting and selling agreements.[10] These secondary markets ordinarily operated between the bid and asked quotations[11] set by the funds from day to day. Among the factors contributing to the activity of this secondary market was the fact that funds would be authorized to redeem shares at a price determined on the day after the one on which shares were turned in for redemption. Thus the redeeming stockholder had to wait at least a day to determine the liquidating value of his shares and even longer for his cash. The dealer or distributor making a market would ordinarily repurchase such shares at a known price and immediately pay cash. Consequently even when offers were made slightly below current asset value, individuals and dealers would sell to the street trading houses to obtain an "immediate market" rather than selling shares back to the underwriter. Also, distributors in many cases could act as principals, repurchasing fund shares and selling them to other dealers or individuals without tendering them to the fund for redemption. This provided a source of profit in addition to the sales load.

The over-the-counter market in fund shares prior to 1940 has been analyzed as falling into four different groups:[12] (1) principal distributors which had the exclusive right to purchase shares from the fund for sale to the public through dealers; (2) "trading firms" that bought and sold fund shares from and to retail dealers, other trading firms, or principal distributors, but not generally the public; (3) "retail dealers" who sold to investors and bought and sold largely to execute customers' orders; (4) the investing public.

The operations by the principal distributors, contract dealers, and "bootleg" non-contract dealers in making trading markets at prices competitive with the fund's current offering and redemption price had the effect of disrupting the established offering price and resulted in the price cutting competition mentioned above.

3. Certain Trading Practices and the "Two-Price System"

The markets maintained by the non-contract dealers and by those authorized distributors and dealers (whose selling agreements didn't prohibit the practice) was facilitated by a pricing system which enabled such firms to maintain an inventory during rising prices which could be liquidated immediately without risk to them in the event of a decline.

As previously noted, some fund distributors and contract dealers engaged in trading activities in shares of the funds to which they were contractually bound as a means of achieving profits in addition to the ales load. Before outlined the operation and effects of the two-price system such techniques will be illustrated.

a. Trading Against the Load[13]

In cases where the dealer acted as principal and received a buying order, the necessary shares could be furnished from the dealer's inventory, purchased either from some other dealer (usually at a discount), from the distributor, or borrowed for delivery if the dealer was short the shares. Similarly, if the dealer were acting as agent in such a transaction and the distributor were acting as principal, shares could be obtained by the distributor either from his own inventory, the fund, or borrowed for purposes of delivery.

In a transaction, where both dealer and distributor acted as agents, the published sales load paid by the investor was returned by the fund to the principal distributor, who realized a portion of it to the contract dealer.

In the first type of transaction noted above, where the dealer acted as principal, the profits on a buying order could be substantially increased. If the dealer held a long position at a price equal to current liquidating value and received a buying order which he filled with such shares, he received the full amount of the load, as the distributor was not called upon to furnish the shares. The matching of a selling order with a purchases order also accomplished this result. If the cost of his inventory position of one share was less than current liquidating value, he made this difference plus the load. If the cost of his inventory position was more than the current liquidating value, he still made profit over and above his normal percentage of the load, up to a point where the cost of his inventory position was equal to the wholesale price.

Thus, the dealer on any inventory position always had the full amount of the load with which to hedge. In addition, the dealer had the safeguard of always being able to turn in his inventory to the principal distributor for redemption or resale and receive the current asset value.

Opportunities similar to those enjoyed by the dealer were also available to the principal distributor, although more limited in their scope. Because the distributor could not secure any more of the load by acting as principal than he could by acting as agent (unless he sold retail), profits on an inventory position could only be derived from a favorable price differential between inventory cost and current asset from of the shares.

As in the case of the dealer, the distributor could utilize that portion of the load retained to hedge his inventory position. However, he could not immediately liquidate his inventory position to the investment company because of the one day lag usually incurred in determining the redemption price. This factor introduced an element of risk in the distributor's trading position.

b. Trading Against the Fund and Riskless Trading

The two-price system[14] which was prevalent in the industry before the 1940 Act was passed involved the use of the previous day's closing market values to determine the current offering price of the company's shares.

The price so established became effective during the morning (10 a.m.) of the next day. After the close of the market (3 p.m.) on any day, dealers and distributors would know both the current and next succeeding per share price. Transactions could be effected at either price by placing orders after the market closed on a trading day or waiting until the following day.

Sales, for example, during Tuesday were based on Monday's closing quotations for the portfolio securities, but the dealer or distributor did not have to deliver shares until several days later so that it wasn't essential to take down shares immediately upon confirmation of the order at the effective price on that day. This ability to defer purchases enabled the distributor or dealer during the period from Tuesday at 3 p.m. to Wednesday 10 a.m. to choose without risk, between the price based on either Monday's or Tuesday's closing quotations.

Short positions could be taken, therefore, at little risk,[15] and inventories could be profitably maintained during rising prices which could be liquidated immediately without risk, in the event of a decline.

Those contract dealers whose selling agreements prohibited their engaging in such activities were at a disadvantage with respect to profit potential and, because they could only offer shares at the offering price described in the prospectus, were unable to meet the lower prices of their non-contract competitors. This led, as previously noted, to the cancellation of many selling agreements.

c. Dilution Effect of the Two-Price System

The dilution occurring in the net asset value of outstanding shares resulted from the fact that under the two-price system in a period of rising prices new shares were purchased at less than current asset value. If Monday's close resulted in a $10 price for Tuesday and the market rose on Tuesday resulting in a $12 price to be effective Wednesday morning, shares could be purchased at $10 from Tuesday at 10 a.m. until that time on Wednesday.

Thus every share bought at $10 was bought below the actual current asset value at the time of purchase. In declining markets the fund would receive less than the current asset value at the time of sale.[16]

4. The Origin and Legislative History of Section 22(d)

The provisions of Section 22(d)[17] were not contained in the original bill which the Commission proposed[18] but were first suggested on April 26, 1940 by Arthur H. Bunker, Executive Vice President of the Lehman Corporation, who was speaking as a representative of the closed-end and open-end sections of the industry.[19] He suggested that Section 22 as then written, be amended to "--also provide that no securities issued by an investment company shall be sold to insiders or to anyone other than an underwriter or dealer except on the same terms as are offered to other investors."[20] This suggestion was embodied in the memorandum of agreement in principle between the Commission and industry representatives which was submitted to Congress on June 14, 1940,[21] and formed the basis for Section 22(d) as finally enacted.

The industry was not unanimous in their support of the provision and several firms expressed their opposition in telegrams and correspondence[22] and at the Commission table.[23]

The legislative hearings do not contain the reasons why the industry desired such a provision but its objectives apparently were well known by the industry and the Commission. The section appears to have been primarily aimed at the increasing practice of retail fund dealers canceling their selling agreements with fund underwriters to enter the "bootleg market" where, because of the then current pricing system, greater profits could be made by "trading against the fund" or "trading against the load." The non-contract dealer upon canceling his sales agreement was in a position to buy shares either from the fund, other dealers, or from investors and either retain the shares for resale to a customer or back to the fund. Sales to the fund were relatively "riskless" because of the "two-price" system, and by reselling the shares acquired from sources other than the fund's underwriter the dealer was able to "trade against the load," i.e., retain the full sales load as compared with the lesser dealer concession he would keep if he were party to a sales agreement. "Trading against the fund" was facilitated by the pricing method which enabled the dealers to effect transactions at either the current price or the next succeeding price by withholding orders for several hours.

Because the legislative history is silent as to the precise reasons for the industry's desire for the fixed price provision, we must assume that the mutual fund managers determined that unless retail price competition were eliminated the continuous growth of the funds through new sales would be endangered. If we look to statements made subsequent to the passage of the '40 Act we find that the reasons given for Section 22(d) not only refer to questions of fund distributions, but also to non-preferential treatment of investors.

In 1958 the NASD claimed that the pre-1940 pattern of mass cancellations of sales agreements would have led to "a situation of redemptions exceeding sales which would not be in the best interest of the remaining shareholders." And the primary goals of Section 22(d) were described as "(1) to insure the orderly distribution of open-end investment company shares; (2) to prevent discrimination or preferential treatment, in price as between members of the public; (3) to prevent certain undesirable practices which had existed prior to enactment of the '40 Act."[24]

B. <u>NASD Rules Relating to Section 22(d)</u>

1. <u>Original Proposal and SEC Comments</u>

On March 14, 1941 the NASD filed with the Commission[25] a proposed amendment to its Rules of Fair Practices which consisted of Article III, Section 26.

By its terms Section 26 applies to the activities of NASD members with respect to mutual fund shares and was adopted pursuant to the authority granted the Association in Section 15 A(j) of the '34 Act and 22(a), (b) of the '40 Act.[26]

As was the case with Section 22(d), segments of the industry were opposed to these NASD rules.[27] However, when submitted to a vote of its membership the necessary majority approved.[28]

Because of the objections a public conference on the rules was held on March 28, 1941, at which the industry objections mainly focused on paragraphs (e), (h), and (j)(2).[29]

Paragraphs (e) and (h) are concerned with the method of pricing fund shares for purposes of sales and redemptions. Generally they were designed to lessen the diluting effect inherent in the two-price system discussed above. One group wished to retain the then existing pricing system while another -- believing paragraph (e) did not go far enough -- sought to eliminate dilution entirely by requiring that each share sold be priced at the market at the time of sale or that orders be held and not confirmed until a recomputation of portfolio values could be made. The Commission's opinion, which did not disapprove Section 26[30] stated that "it is [not] our duty to attempt to resolve this disagreement at this time... the Association should be given reasonable latitude in attempting to work out a practical solution to the problem of dilution... Accordingly we shall not interpose any objections to the effectiveness of paragraphs (e) and (h) of the proposed rule... we are neither approving these paragraphs nor inferring in any way that they are adequate to solve the problems to which they relate."[31]

Paragraph (j)(2) which was attacked by the non-contract fund share dealers as discriminatory, prohibits a fund distributor from repurchasing fund shares from a non-contract dealer acting as principal or an investor unless each is the record owner, even though the investor or dealer is the actual owner. Its principal effect on the non-contract dealer was said, "... to force him to run the risk of a change in the redemption price of shares during the time it takes to become record owner."[32] The opinion also pointed out that paragraph (c) in effect required sales agreements between the fund its principal underwriter and dealers by prohibiting a principal underwriter from selling to another member at a concession from the public offering price unless a sales agreement was in effect between the parties. And that Section 22(d) of the '40 Act prohibited dealer concessions to investors while fund shares are being publicly offered.[33] The Commission conceded that paragraph (j)(2) "... certainly discriminated against dealers who do not have a sales agreement with an underwriter," but thought that in context with the provisions that impose restrictions on contract dealers such as, paragraph (i) and (j)(1), it was "... by no means clear that the rule will operate in an unfairly discriminatory manner."[34]

The Commission apparently did not foreclose the possibility of there being a rather limited market in fund shares because after noting that the peculiarities of open-end companies justify the provisions of the rule it was observed that

"A secondary market is maintained in shares of open-end investment companies which more closely resembles the traditional over-the-counter market in other securities, but this market exists only in the range between the public offering price and the redemption price of the shares. Transactions in this secondary market are not prohibited by paragraph (j)(2), which applies exclusively to the redemption of shares."[35]

2. Amendments to NASD Investment Company Rule

Since its enactment Section 26 has remained in its original form with minor exception[36] but along with other NASD rules has recently been the subject of proposed revisions by the Commission and the NASD.[37]

A preliminary draft of the proposed revisions contained a paragraph which would have prohibited sales of fund shares by contract dealers at a discount from the public offering price to another broker-dealer unless such other broker-dealer was a party to a sales agreement with the underwriter of the securities[38] covering the particular shares.

The proposed revisions probably will not be acted upon by the NASD before the summer of 1964[39] and in present form would not affect the operations of the trading market in fund shares.

C. The Effect of Section 22(d) on the "Bootleg Market"

Section 22(d) has apparently been effective in eliminating the practices of the non-contract "bootleg" dealer. Because a dealer is prohibited by Section 22(d) from selling to investors at a price below the public offering price if shares of the same class are currently being publicly offered, the primary appeal of the bootlegger - the bargain price - is eliminated.

An early Commission release indicated one permissible situation where a sale below the public offering price might occur:

"...the term 'dealer' as used in Section 22(d) refers to the capacity in which a broker-dealer is acting in a particular transaction. It follows, therefore, that if a broker-dealer in a particular transaction is acting solely in the capacity of agent for a selling investor, the sale may be made at a price other than the current offering price described in the prospectus... On the other hand, if a broker-dealer is acting for his own account in a transaction and as principal sells a redeemable security to an investor, the public offering price must be maintained, even though the sale is made through another broker who acts as agent for the seller, the investor, or both."[40]

The NASD similarly has stated that where a sale takes place below the public offering price from an investor to another investor through a member who acts as agent for either or both, Section 26 of the Rules of Fair Practice is not violated and "This is a proper transaction under Section 22(d)..."[41]

The combined effect of Section 22(d) and Section 26 of the Rules of Fair Practice was the elimination of riskless trading and cut-price distribution of fund shares. The presently existing trading market in such shares is such smaller than the pre-1940 market and operates within the permissible price restrictions and contractual arrangements countenanced by the Commission's and NASD's rules.

II. Operation of the Present Trading Market in Fund Shares

A. The Operation of Asiel & Co., and Smith, Burris & Co.

Only two broker-dealers presently make trading markets in mutual fund shares. Because of the similarity in their operations a separate account of each is not given. Specific attention is given to Smith, Burris and differences are noted with respect to Asiel.[42]

Most of Smith, Burris' business consists of trading O-T-C securities on a principal basis with other dealers. Mr. Erzberger, the firm's President, estimated that about 50% of his time is devoted to market making activities in fund shares and that their dollar volume represented a little over 50% of his total trades. The firm is not a member of any securities exchange and has a total of nine employees. Asiel is a member of the NYSE, Amex, and does a general brokerage business.

1. Size of Their Market: Number of Funds and Dollar Volume

Although Smith, Burris has made markets in many different funds over the years - depending on their popularity with investors -it presently makes markets in about 20 funds. Quotations are placed in the regional “pink sheets” at Mr. Erzberger's direction with several funds being quoted in more than one regional market. Mr. Erzberger estimated that he was presently maintaining 25 to 30 quotations on 18 funds.[43]

Asiel, which like Smith, Burris does about 99% of its business with other broker-dealers, generally makes a market in above five to ten funds. As of March 12, 1963, it made markets on the shares of M.I.T., M.J. Growth, Wellington, Chemical, Affiliated and Capital Life Insurance. Mr. Litt, the firm's Managing Partner, said that fund shares trading constituted a very small part of Asiel's total business.

2. <u>Participants in this Market: Whom Does Smith, Burris Sell To? Buy From?</u>

Smith, Burris acquired fund shares primarily from broker-dealers and, to a lesser extent from banks, which do not have sales agreements as to such shares with the fund or its distributor. Only rarely are shares acquired directly from individuals. Mr. Erzberger said that sales agreements generally require dealers to sell back to the fund the shares turned in for repurchase or redemption. Thus, even though Smith may be offering to purchase shares of a particular fund at a price above the net asset value, the dealer is required to sell the shares to the fund. Mr. Erzberger said that he thought these provisions in sales agreements caused the dealer to violate his fiduciary duty to his customer.

Frequently, Smith, Burris and Asiel will offer to purchase fund shares at less than the net asset value, the price offered by the market maker depending on supply and demand, the firm’s long or short position and the contemporaneous trend in the Dow-Jones average. Recently Smith, Burris has had an oversupply of M.I.T. shares and its bid has been below the net asset value.

Sales will be made to Smith, Burris even at this price by those dealers who desire an “immediate market” and do not wish to wait for the price they would receive to be determined as of the date the fund receives the shares.

Asiel will also frequently buy from Merrill Lynch, Pierce, Fenner & Smith Inc. (“MLPFS”) at $.05 to $.25 above net asset value and hold the shares for resale to other brokers at a price slightly below the then current offering price. The brokers deliver shares at the public offering price against an investor’s purchase order.

Both Asiel and Smith, Burris stand to make a profit on any appreciation in value of those shares held in inventory or depreciation on short positions.

Purchasers of fund shares from Smith, Burris are dealers who do not have a selling agreement with the fund whose shares they buy. Usually the price at which Smith, Burris will sell the shares equals or is below the net asset value plus the underwriter's spread.[44] A typical transaction was described by Mr. Erzberger.

On June 26, 1963, Smith, Burris sold 500 M.I.T. to MLPFS @ $15 net. That day the applicable prices were $14.77 bid; $16.14 offered. That day if MLPFS sold M.I.T. to an investor it would have to charge $16.14 (the public offering price). Their profit would have been $1.14 per share.[45] There is no advantage for an investor to buy from Smith, Burris since it can only sell to him at the public offering price.

In theory, at least, every dealer who trades with Smith, Burris does not have a sales agreement with respect to the fund shares traded.

Mr. Erzberger estimated that during the first half of 1963 transactions were had with over 100 broker-dealers, with substantially more than 25% of all transactions occurring with MLPFS. Of the transactions with MLPFS Smith, Burris, was a seller in a majority of cases.[46]

Mr. House, Asiel's Trading Partner, estimated that about 96% of his firm's fund share trading was with MLPFS.

In addition to potential price advantage and price certainty a dealer may find it more convenient to deal with Smith, Burris. For example, if a dealer has shares of several different funds to liquidate, he need not mail the shares to the several different funds for redemption; instead he can sell all the shares to Smith, Burris in one package.

3. Relationship to the Funds

Smith, Burris receives no portfolio brokerage business from the funds as a means of encouraging it to make a market in their shares. Mr. Erzberger believes that none of the funds wish to encourage this type of business because they want as many dealers as possible to sign sales agreements for their shares and thus permit the principal underwriter to sell their shares and earn its commission. He believed that Vance, Sanders didn't object to Smith, Burris' activities but mentioned that others had given him a hard time when Smith, Burris, as record-owner, turned shares in for redemption.

Asiel does, however, receive fund brokerage and the funds do not appear to be discouraging this phase of their operations by withholding such portfolio business.

4. Activities in No-Loads, Lazard Fund and State Street Fund

Smith, Burris does not trade in no-load shares but makes a market in Lazard Fund and State Street Funds.[47] However, its volume in such shares is relatively small. Other firms such as Blyth & Co. make markets in the shares of these funds. Smith, Burris get no reciprocal business from these funds but Mr. Erzberger believes both funds approve of his activities because they reduce the number of shares tendered for liquidation.

Asiel did make six purchases of Scudder Fund, a no-load, representing only 8% of its total purchase transactions in the six-month period ending July 31, 1962. Shortly after purchase all the shares were liquidated to the fund. It was believed that this was because it was a no-load and there is little dealer interest in such funds.[48]

Of the 14 funds listed in Exhibit 1, Lazard Fund ranked 14th in both number of shares purchased and sold (including liquidations) by Smith, Burris during 1962. State Street Fund ranked 9th in both categories in this period.

In the first six months of 1963 Lazard again was 14th and State Street was 10th and 8th respectively as to shares purchased and sold.

Asiel's trading volume in shares of these funds appears to have been relatively greater, even though the periods of comparison are not identical.[49]

Of the 20 funds listed in Exhibit 2, (including the "sundries" account which reflects an undisclosed number of funds) Lazard Fund ranked 3rd in both number of shares purchased and sold (excluding liquidations) during the seven-month period ending July 31, 1962. Shares of this fund represented 10.2% and 15% respectively of total shares purchased and sold.

State Street ranked 6th in purchases and 4th in sales during this period representing 7.6% and 11.2% respectively of purchase and sale volume.

B. The Operations of Merrill Lynch, Pierce, Fenner & Smith Inc.

MLPFS's participation in the inter-dealer mutual fund share trading market, as a source of supply for their customers demand for fund shares, results from the absence of underwriting or sales agreements between MLPFS and any fund.[50] No such agreements are presently contemplated, and since it commenced operations, it has been the firm's policy not to enter such agreements and not to recommend mutual funds as an investment medium for its customers. On occasion the firm will recommend closed-end companies. All mutual fund share purchases or redemption transactions arise from unsolicited customer orders.

Transactions in Mutual Fund Shares

Customer orders from all MLPFS branch offices are cleared through the Marketing Department at the home office in New York. The firm will handle a customer's order for shares of any fund and has no selected list. For Example. In June 1963, shares of 54 funds were either bought or sold.

What the firm does when a customer wishes to sell or liquidate

When a customer wishes to dispose of his fund shares through the firm, it will either (a) transfer the shares to the firm's name and confirm out, as principal, to another customer on the basis of his corresponding buy order; (b) sell the shares as the customer's agent to Asiel & Co. or Smith Burris, Co.; (c) tender the shares to the fund for redemption in the customer's name; or (d) transfer the shares into the firm's name and tender them for redemption to the fund.

A little over 90% of the selling orders come from individuals. Banks and other institutions account for the balance of such orders, but the orders from the banks were believed to be mostly as nominee for individuals rather than for the bank in its capacity as trustee. Because it is the firm's policy to transfer all securities into the firm's name when received, the firm does not simply "cross" shares, as agent, with a corresponding customer order.[51] It will, however, "pair off" recently acquired shares against a buy order, before attempting to fill it from other sources and in so doing, will take the shares into inventory for an estimated average period of one or two days. The firm acts as principal on both sides of the transaction.

The firm's policy is not to inventory fund shares for investment but only to carry a position for several days in order to fill immediate customer requirements.

Mr. John Warren, Assistant to the Manager of the Marketing Department, estimated that such "pair offs" including shares drawn from a one or two day inventory position, represent about 10% of all fund share transactions.

MLPFS as a matter of policy transfers as many securities as possible into its own name. By virtue of the practice it was claimed that the firm becomes record owner of the books of the fund's transfer agent so that the requirements of Section 26(j)(2) are satisfied.[52] Since all shares of the same class are treated as fungible when taken "into the box," in a redemption situation the firm does not necessarily deliver the redeeming customer's securities to the fund. MLPFS will disclose the selling customer's identity to the fund at its request.

In all cases where shares are sold by MLPFS to Asiel or Smith, Burris, and a premium over the fund's quoted redemption price is obtained, it is passed on to the customer.[53]

b. What the firm does when a customer wishes to buy

Over 90% of the buy orders for fund shares are received from individuals and, as was the case with sell orders, bank-originated buy orders are believed to come mostly from individuals.

When a customer wishes to buy fund shares which are not available by virtue of a fairly contemporaneous sell order or from inventory, the firm calls Asiel and Smith, Burris[54] and buys from the firm giving the best price.[55] Only enough shares to fill existing customer orders would be bought. MLPFS will always buy for its own account and resell as principal to the customer at the prevailing public offering price. And as previously mentioned, the firm does not cross orders in the capacity of agent for buyer and seller. Thus no customer receives fund shares at below the public offering price.[56] Although MLPFS makes a profit by virtue of the difference between the public offering price paid by the customer and its cost, it was emphasized by Mr. Warren that the firm regarded fund share transactions essentially as a customer service and not a type of business to be actively sought.

Mr. Warren stated that MLPFS does not have to buy directly from the funds because Asiel or Smith, Burris will always quote on fund shares even if they may have to go short the shares to do so. Thus, Mr. Warren stated MLPFS has never had to buy fund shares directly from the fund underwriters. If it did have to fill orders from the fund underwriters MLPFS would have to pay the full public offering price because it would not be party to a sales agreement with the underwriter.[57]

2. Charges to Customers

The firm's policy with respect to fees charged in handling fund share transactions is covered in its Operations Manual, Section 6(a). In summarizing its provisions Mr. Warren said that when a customer is buying mutual fund shares he pays the public offering price and no transaction or service fee is charged.

On sell orders the firm's Branch Office Managers have discretion as to whether or not to charge a commission. This determination is based upon whether the customer will reinvest at least part of the proceeds through the firm and how long the customer has had an account with the firm. Generally new customers are charged after being informed of the fact before the order is accepted. This charge generally amounts to the regular OTC transaction charge applicable to other OTC shares of the same price and quantity (equally the NYSE rate). Occasionally a lesser negotiated charge is made.

It was estimated that this results in the firm imposing a commission in only about 5% of such transactions. Salesmen at MLPFS receive the same compensation or credit on fund share transactions as they do on transactions in other shares.

3. Volume of Fund Business at MLPFS

MLPFS' fund sales represent only a small fraction of the total annual national sales figures of about $2.5 billion.[58]

Based upon volume figures for June, 1963,[59] it is estimated that the firm's 1963 volume of fund sales to customers amounted to about $2,599,000.[60]

Table 1 summarizes the estimated 1963 volume of MLPFS's sales to and purchases from customers, Smith, Burris, Asiel & Co., and mutual fund principal underwriters. It may be noted that the firm sold similar amounts to Asiel & Co. and Smith, Burris and that the ratio of agency-to-principal transactions was almost the same for both. However, purchases from Smith, Burris were a little over two times the amount purchased from Asiel & Co.

Mr. Warren advised that MLPFS makes no conscious allocation of sales between Smith, Burris and Asiel and that the similar ratios were accidental. The greater amount of purchases from Smith, Burris were explained by the fact that lower prices generally were obtainable from that dealer during 1963.

TABLE I -MLPFS' FUND SHARE DOLLAR VOLUME 1963

	Customers		Smith, Burres		Asiel & Co.		Fund Underwriters	
	As Agent	As Principle	As Agent	As Pncpl	As Agent	As Pncpl	As Agent	As Pncpl
Sales To:								
	None	$2,599,000	$302,380	$77,682	$305,738	$77,130	$17,869,028	$53,407
Purchased From:								
	None	$952,380	none	$1,190,643	none	$540,310	none	none

III. Impact of Fund Share Trading Market on Uniform Price System

A. Effect on the Customer

When purchasing currently offered fund shares from a dealer, Section 22(d) of the '40 Act requires a customer to pay the fund's public offering price. This is true even if the selling dealer does not have a selling agreement with respect to the particular fund shares or any fund shares, as is the case with MLPFS. Thus the fund share trading market has no effect upon the uniform purchase price at the customer level.

B. Effect on Dealers

By virtue of Section 22(d) retail dealers can no longer compete for fund share business by offering bargain prices to their customers. Furthermore their ability to "trade against the fund", as previously indicated, is seriously inhibited by Section 26 of the Rules of Fair Practice. Because of these limits the fixed public offering price on sales to customers and the necessity of becoming record owner in order to redeem to the fund plus the financial incentive to sign fund sales agreements, the fund share trading market has become so unattractive as to consist of only two wholesale firms and one retail concern that does not encourage fund share purchases.

C. Effect of the Funds

The fund-principal underwriter-contract dealer structure of the fund share distribution system appears to be unaffected by the present trading market. This structure does not appear to be threatened by the fact that non-contract dealers can frequently buy fund shares from Asiel or Smith, Burris at or below the net asset value and resell to a customer at the public offering price, thus realizing a profit per share greater than the contract dealer's.[61] Dealers are not, however, canceling their sales agreements. The liberal dealer concessions,[62] promotional literature and other sales aids provided by the principal underwriters, the opportunities to acquire management company stock, and the receipt of reciprocal brokerage and give-ups appear to represent a greater source of profit to dealers than the spread obtainable by wholesaling fund shares like Asiel and Smith, Burris or retailing them in a manner similar to MLPFS.[63]

CHAPTER TWO: THE INDEPENDENT RETAILER

Introduction

The Special Study has described the three basic organizational structures by which mutual fund shares are distributed to the investing public as (i) fully, (ii) partially, and (iii) non-integrated.[64]

The fully integrated organization is exemplified by Investors Diversified Services and consists of a retail sales force directly employed by the fund's affiliated principal underwriter. No separate retail dealers are involved and only shares of its affiliated funds may be sold to the public by the sales force. Since there is no occasion for use of the inter-dealer discount permitted to NASD members by Section 26(c) of the Rules of Fair Practice, the fully integrated sales organization, need not be an NASD member.

In a partially integrated distribution organization the sales of the fund's share are made by the retail salesmen of its affiliated principal underwriter, and also through independent retail dealers. Both the principal underwriter's salesmen and the independent retail dealers, which have selling agreements with the principal underwriter, also sell the shares of other funds. Waddell & Reed, distributor of the United Funds, is an example of such an organization.

The majority of mutual funds distribute their shares by means of a non-integrated distribution organization. Typically the affiliated principal underwriter employs no retail salesmen but may employ wholesale field representatives who generally attempt to stimulate sales in their assigned areas.[65] The underwriter functions solely as a wholesaler and all investor purchases are made from the numerous independent retail dealers which have signed selling agreements with the principal underwriter.

In the detailed descriptions of the five fund complexes previously submitted by the Office of the Special Counsel[66] attention has been focused on the functions of the principal underwriter in the distribution process. This discussion will focus upon certain aspects of fund share distribution at the level of the independent retail dealers, which firms comprise the final institutional link in the chain of the partially and non-integrated distribution structures.

Nine firms were interviewed for this part of our study[67] during August, 1963. All did a substantial mutual fund business in terms of their own “product mix” and represented three main categories:

(1) New York Stock Exchange member firms;

(2) the regional exchange member firms which are not members of the NYSE; and

(3) broker-dealers which belong to no securities exchange

Representation was sought from among the larger and smaller firms within each group, and with respect to the non-exchange member firms, interviews were had at a general securities firm and two “specialty houses” that sold mutual funds almost exclusively.

Because mutual fund sales in California have represented about 25% of the national sales figure for several years (despite the exclusion of contractual plans from that state), 7 of the 9 interviews were held in California.

Although the limited number of firms visited precludes industry-wide generalizations, our purpose was to make a pilot study of the internal cost allocations, if any, within the multiline securities firms, and if possible, to assess the relative profitability of the several types of securities sold. We also wished to study the effects of selected lists, variations in fund sales commissions, and special incentives upon fund sales in the several types of firms visited. We also hoped to gain a first-hand understanding of mutual fund marketing problems faced by the different types of firms.

I. The Retail Dealers Interviewed

A. NYSE Members

E.F. Hutton & Company

This firm is one of the largest members of the New York Stock Exchange and does a general securities, underwriting, and commodity business. The Beverly Hills office at which our interviews were conducted is one of 43 branch offices. Its personnel include 3 supervisors, 17 salesmen, and 11 back office employees. The Beverly Hills office relies on the research facilities of the firm's main office in New York City and for certain administrative functions on the senior personnel of the Los Angeles office which serves as the company's Western Division headquarters. Certain administrative expenses of the Los Angeles office are charged to the Beverly Hills office and the other branch offices under its jurisdiction.

Most of the office's income is derived from agency transactions in NYSE securities. Mutual funds, commodities, and OTC securities account for about 2%, 9% and 8% respectively, of gross commission business.[68]

Mr. Dedrickson, the Office Manager, described the competition in his area as extremely intense because of its concentration of wealthy residents and illustrated his observation by pointing out three “tape watchers” in the board room whose portfolios were valued between one and ten million dollars. There are branch offices of about 30 other NYSE member firms in the Beverly Hills community.

Dean Witter & Co.

Our interview was held at the firm's main office in San Francisco which also functions as the headquarters for the entire firm's Northern Division. In addition to its main office, the firm maintains 52 branch offices throughout the country which are grouped into three other divisions. We were told that much of the data in which we were interested was, until recently, maintained both in New York and California but that with the introduction of electronic data processing machines, most of the firm's and regional office figures are developed and stored exclusively in its New York office.

As of June 30, 1963, the firm employed approximately 590 registered representatives of which roughly 35 worked in the main San Francisco office. No salesmen or supervisors devote all of their time to fund sales.

The firm's business is primarily in New York Stock Exchange brokerage and for their fiscal year ending January 31, 1963, mutual funds accounted for just a little over 4-1/2 percent of their business on a gross commission basis.

Mitchum, Jones & Templeton

We spoke with the company's chief executive personnel at its main office in downtown Los Angeles. The firm's 10 branch offices are concentrated in California except for a two-man branch office in Reno, Nevada and a wire center and administrative office in New York. No sales are made out of the New York office which handles all the New York Stock Exchange orders for the company.

The company employs about 200 people, including 82 registered representatives, 30 of whom operate out of the main office. Research is conducted in both its Los Angeles and San Francisco office.

About 55 percent of the firm's total gross income was estimated to come from agency commission business while principal transactions in over-the-counter securities and new issues were estimated at about 35 percent. Mutual fund business and miscellaneous transactions account for the remaining 10 percent.[69] We were told that despite the doubling of the firm's gross business within the last five years, its mutual fund volume fell in the past year by about 50 percent. This fact has been extremely disappointing to the company's president, Richard Jones, whose business philosophy has been aimed at building the mutual fund business: "... we are very much interested in building our mutual fund business, and we have gone to great extremes to do so and despite our efforts our mutual fund volume is sliding in the wrong direction."[70] It was estimated that fund sales for the 12 months prior to August, 1963 approximated $2,600,00 whereas they had been previously running in the neighborhood of $5,000,000.

Richard Jones' strong emphasis on fund sales was said to go back to his training in the business as the "understudy" of Dudley Cates, recently retired president of Waddell & Reed. In order to put his convictions into practice, Richard Jones caused the firm to purchase an existing mutual fund specialty house in April 1960, with the idea of creating a specialized subsidiary.[71] This venture proved to be a financial failure, attributable in part to the high costs of training registered representatives and the high turnover of such personnel.

B. Regional Exchange Members

Pacific Northwest Company

The Company, an outgrowth of the merger of two brokerage firms in February 1945, is a wholly owned subsidiary of United Pacific Corporation, a publicly held holding company whose other subsidiaries include an insurance company and an SBIC. It acts as the investment adviser and principal underwriter for Equity Fund, Inc., but also retails a substantial amount of other funds' shares. The Midwest Stock Exchange (MSE) is its only exchange membership.

In addition to its main Seattle office where we conducted our interview, there are 13 branch offices in Washington, Oregon, and Idaho. About 70 full-time employment work at the company's main office, consisting of 50 salesmen, 10 in back-office jobs and 10 supervisors, including the company's six principal officers.

A break-down of the company's recent business, on a gross profit basis (dollar volume figures were not kept) was estimated to be 50% in OTC stocks, 20% in mutual funds (including Equity Fund), 10% in underwritings, 10% in municipal bonds, and 10% in listed and miscellaneous business. In previous years underwriting profits represented about 25% of the total.[72]

The company makes markets in some 16 issues which are for the most part located in the northwest, but does not trade the stock of its parent company. About 75% of its customers are individuals and 25% are brokers and institutions.

Relationship to Equity Fund

Since the fund's inception in 1932, Pacific Northwest has been Equity fund's investment adviser and principal underwriter and receives a fee of 1/6 of the fund's net profits (defined as net income including realized gains or losses on investments) before charges for investment advisory services and all taxes (except stamp taxes), provided the total fee does not exceed 1-1/2% of the fund's average monthly net asset value (before provision for this fee). No investment advisory fee is payable for any quarter unless the net asset value of the fund at the end of the quarter plus dividends paid since January 1, 1940, exceeds the total net proceeds received by the fund from the sale of its shares. Exhibit 3 illustrates the results of this formula in terms of dollars paid under the agreement and as a percent of net assets.[73]

Equity Fund is sold with a maximum load of 3-1/2% and is distributed exclusively by Pacific Northwest because a dealer concession competitive with other funds cannot be offered out of the low sales load. Robert F. Daniel, the company's President, explained that the low-load gives the salesmen a competitive talking point with respect to the standard load funds. The company's salesmen receive 3% out of the 3-1/2% load, thus equalizing their compensation with their normal commissions of 50% of the standard 6% dealer's allowance paid on other funds.

Sales of Equity Fund during the first 6 months of 1963 represented about 1/2 of the company's total fund sales.

First California Company

From 1950 through June 1963, the firm was owned by Pepsi Cola United Bottlers. Holmstad Allen & Co., a small investment banker in Los Angeles acquired its stock in June 1963, but after operating under the new owners for about two weeks, the senior personnel at First California Company decided that they would attempt to buy the entire firm from Holmstad Allen because of dissatisfaction with the new owners. During July, 1963 they informed Holmstad Allen that all the senior personnel would resign unless they were given the opportunity to purchase the firm. At the time of our interview, the details of the proposed purchase by the employees had not yet been formalized but we were advised that each employee would have a stock interest in the firm and that a portion of the equity would be held by an employees' stock bonus plan. We were told that a “cooperative” ownership by its employees of a brokerage firm of this size would be unique in the industry. On September 12, 1963, the Wall Street Journal carried the announcement that the firm had been purchased by its officers, employees and sales representatives.

The firm is a member of the AMEX (Associate), PCE and MSE and has 30 branch offices concentrated in California and Oregon. In its main San Francisco office where we conducted our interview, there are approximately 100 employees of which 18 are registered representatives.

In addition to its retailing activities, the firm makes markets in about 12 securities in San Francisco where it employees 6 traders. It also makes markets in about 12 different securities in its Los Angeles and Portland offices where different traders are employed. The securities in which it makes markets were described as those in which the firm was interested in retailing. One employee devotes his entire time to the development and servicing of fund portfolio business, including the maintenance of records of the reciprocity received by the firm for its sales efforts. On a gross commission basis, mutual fund sales represent about 20% while over-the-counter and listed business represent 7%

and 23%, respectively. Gross income from participation in underwritings represented about 50% of total income. We were advised that the firm is trying to increase its mutual fund volume from its present level.

C. Non-Exchange Member Firms

Southwick, Campbell & Waterman Co.

Southwick, Campbell & Waterman Co., Seattle, Washington was formed in October 1960 as a result of the merger of Earl F. Waterman Co., which specialized in mutual funds, with Southwick-Campbell & Co.

The Company has no branch offices and is not a stock exchange member but does get a preferred rate on the PCE. It is a medium-size, non-exchange member that does a substantial fund business. In addition to its three principals who have their own customers, there are 3 full-time salesmen, one person in research and 4 in clerical capacities.

On the basis of the firm's gross commission, mutual funds represented about 60%, listed, 1/2%, OTC stocks, 6-1/2%, and municipal bond underwritings accounted for the remaining 30% during the first half of 1963. During that same period, on a dollar volume basis, fund, listed, OTC and municipal bond sales were respectively about 38%, 4%, 14%, and 32%. The firm occasionally participates in a selling group for the underwriting of a local issue but has no trading department and does not make markets in any securities. It will occasionally accumulate securities in inventory for ultimate retail sale.

The firm's customers are primarily individuals but most of its municipal bond business is with insurance companies and credit unions.

California Investors

First Mutual Investors d/b/a California Investors commenced operations in 1957. It belongs to no securities exchange and, in addition to its main Los Angeles office, operates seven branch offices located in Southern California. The company employees 11 executives and 72 salesmen, 3 of whom are part-time.

The company dropped its membership in the Pacific Coast Stock Exchange (PCE) in May 1963 and soon thereafter discontinued its research department and began to recruit part-time salesmen in an attempt to concentrate on its mutual fund business. On a gross commission basis fund sales accounted for about 75%, OTC sales 12%, and listed stocks 14%, during the first half of 1963.

As compared with a 1961 net profit of about $120,000, the firm lost $113,000 in 1962 and for the first half of 1963 its loss amounted to $51,000 (before provision for federal tax credit of $27,000).

Relationship to Mitchum, Jones & Templeton

In April 1960, Mitchum, Jones & Templeton acquired a mutual fund retail firm from F. W. Jones, an uncle of Richard Jones who is President of Mitchum, Jones & Templeton. The purpose of the acquisition was to create a specialized full-time sales force which would acquire the prestige of a NYSE member firm with the eventual goal -if the sales force could be successfully developed -of sponsoring a new mutual fund. Because of unprofitable operations resulting from unanticipated costs of salesmen's training, the subsidiary, in December 1962 -than named MJT Mutual Fund -was repurchased by Frank W. Jones and merged into California Investors.

The firm's unique past association with the NYSE-member firm of Mitchum, Jones & Templeton, however, is not completely severed. F. W. Jones has a 20% stock interest in California Investors which, in turn, gives about 90% of its listed securities business to Mitchum, Jones & Templeton.

Mutual Fund Associates, Incorporated

Since its inception in 1951 as a sole proprietorship, the company whose principal office is in San Francisco, California, has always concentrated on the sale of mutual fund shares and contractual plans and presently such sales represent 90 percent of its dollar volume of securities transactions. The company offers shares of about 100 funds constituting all funds qualified for sale in California and the other states in which it does business.

As of August 1963 the company operated 34 offices in 7 western states and employed 742 persons of whom 222 were full-time salesmen, 504 part-time salesmen, and 63 were engaged in supervisory capacities, but devoted part of their time to sales activities. During the calendar year 1961, 448 salesmen joined the firm and 98 left. For the 12 months ending June 30, 1963, 180 salesmen joined the firm, and 375 left. About 52% of the terminations represented salesmen who were with the firm less than one year. The factors accounting for such a high rate of turnover were said to be the market decline following May 1962, adverse publicity about mutual funds, and more vigorous training and termination standards of Mutual Fund Associates. The great majority of its salesmen are hired with no previous experience in the securities business.

Through its wholly owned subsidiary, Investors Insurance Associates, Inc., a variety of life insurance policies are offered by those fund salesmen who are licensed to sell insurance.

The company encourages periodic payment plan investors to sign an average of 12 post-dated checks at the time of making the initial payment. This practice, which has been employed for about 8 years, is used with respect to all plans offered by the company. The company also offers a combination of life and casualty insurance with a mutual fund which it calls "Capital Plan." The insurance policies are underwritten by Federal Life Insurance Casualty Company of Battle Creek, Michigan, which is affiliated with Channing Corporation. The fund aspects of the Capital Plan may consist of any periodic payment plan that the company offers. Less than 1% of the firm's business is represented by Capital Plan sales.

In February 1961, Neil T. Ferguson, the company's President and sole stockholder, sold 1,275 shares of Class A stock to Putnam Management Company, Inc. (Putnam), in exchange for 250 shares of Putnam common stock.

The 1,275 shares which represented 51 percent of the company's outstanding stock was made the subject of a voting trust with Neil T. Ferguson as chairman of its trustees. A concurrent agreement between the company and Ferguson employed him as "Senior Executive," or at the company's option, in other executive capacities, for a 5 year period at $18,000 per year, plus reasonable expenses, not to exceed $7,000.

The company elected to its Board of Directors Arthur T. Layman, Jr., vice-president and director of Putnam, and George Putnam, Jr., president and director of Putnam and Putnam Programs Corporation and treasurer and director of Putnam Fund Distributors, Inc.

Among other things, the agreement provided that the company would continue to be operated as it had in the past and would continue to sell other funds along with the Putnam funds but that it would be appointed a general distributor of the Putnam funds. As such, it would retain the entire sales load but have to pay certain administrative and distribution costs such as transfer agency charges on Putnam plans, blue sky expenses and literature costs.

The firm has had recent financial difficulties as exemplified by a net loss of about $25,000 for the seven months ended July 31, 1962 and consistently increasing subordinated debt which as of April 30, 1963 amounted to about $428,000 ($50,000 of which came from Putnam). In addition, gross income fell about 40% in the 7 months ended July 31, 1963 as compared to the comparable period in 1962. However, because of a severe cost-cutting program involving voluntary executive salary reductions of almost 50% by the three highest paid executives, the firm showed a net profit for the 7 months ended July 31, 1963 of $2,677.

The company's close association with Putnam has resulted in sales of Putnam's shares and plans representing about 60% of mutual fund sales for the 6 month period ended June 30, 1963. Pressures toward such selectivity begin with the home study course which all beginning salesmen are required to take. It utilizes only the prospectuses of the Putnam funds as a basis of study. In addition a 33 question examination is based on those prospectuses and a 20 year performance chart of the George Putnam Fund of Boston, sample orders, contractual plan applications, and letters of intent name the Putnam Funds to illustrate the proper way to make out such forms. Thus a salesman's earliest contacts with available fund literature direct him toward the funds managed by the company's controlling person.

Mary Lou Brown

Mary Lou Brown as a sole proprietor represents the smallest institution in the mutual fund distribution process. One hundred percent of her business is done in fund shares. For most of the time since she registered as a broker-dealer in 1959, she has employed no additional sales personnel. She presently shares an office with an insurance agent and pays half the cost of a common receptionist-secretary. The problems facing the small mutual fund dealer can be viewed through her experiences in the business. She commented on the long hours required of her in trying to sell shares and run an office and the problem of getting a fair share of reciprocity.

Her entire testimony reflected a feeling of frustration apparently based upon her inability to build her firm as she had hoped, and she complained of burdensome federal and state regulations.

She received some notoriety in the business several years ago when she published an article in the Investment Dealers Digest describing the afternoon tea parties which she held for local residents as a means of attracting their interests in mutual funds.

Her clientele are primarily women and her sales approach is highly emotional:

“I believe in American women most of all and I believe American women must fall in love with American industry. They must fall in love like a man ... I am a woman and I know how women think. Let a woman fall in love with something and nothing will keep her from achieving it; whether it is a dress on the corner or whatever it is or a man or anything, she has a different way of approaching it.”[74]

Miss Brown believes that mutual fund literature must be made more palatable and appealing and indeed, has submitted some of her ideas to the Bullock funds. She showed us some brochures that she had prepared with the aid of an artist but confessed that her ideas were not acted upon. She believes that if fund literature could be made more appealing and more women could be interested in selling funds, the mutual fund market could be greatly expanded. She explained her philosophy saying:

“you get women to think differently and you change the politics in this country because it all started with women. You know it and I know it and everybody else knows it. She has to understand this ... she has to understand business; then, no body can take her for anything.[75]

She paraphrased her basic approach to her customers as follows:

"I feel you make a safer chance in this country if you have a cross-section of American industry. If they go down the drain, I don't think you and I are going to be here. If you [want to] get a quality manager, you are going to have to trust a broker. I hope you will trust me enough to do business with me."[76]

II. Costs of Mutual Fund Retailing

Maintenance of Cost Figures

Of the 9 broker-dealers interviewed, no firm had attempted to ascertain its relative costs with respect to the various types of securities (e.g. bonds, listed, OTC, funds) which it merchandized.

Interest was expressed as to whether we knew of any firms that maintained such figures and it was generally agreed that such knowledge would be extremely helpful in planning the type of business to be sought and to economize on present operations. No firm could document its belief as to which type of security was most profitable for the firm.

We generally explored the possibility of generating such figures for a "multi-line" securities firm, and the large NYSE-member firms, Dean Witter and E.F. Hutton, expressed the view that because of the many items of overhead applicable to each line of their business and the difficulty in each instance of arbitrarily allocating employees' time and shared overhead costs, the final figures would not be very helpful.

Eaton Taylor, the partner in charge of mutual funds at Dean Witter said:

"There is no possible way of doing that. In fact the New York Stock Exchange just made a report.[77] It came out that we made more out of brokerage than anybody else, which is a lie.

"No it is practically impossible, unless the stock exchange did it themselves, to come out with any sale breakdown of costs. Our men probably allocated X amount of our wire system to over-the-counter. Another firm might say, 'we need the entire wire system.' So, the figures are completely false and phony that the New York Stock Exchange prepared, there is no possible way you can break it down individually."[78]

The non-NYSE members expressed similar views.

Southwick, Campbell & Waterman was the only firm whose accounting treatment of one "product-line" differed from the treatment given other securities. The travel and legal expenses incurred in connection with entering bids on a municipal bond issue are charged against that particular security in bond reserve account which the firm maintains. All other expenses including mutual funds are recorded as general sales expenses. We were advised that:

"...if we do some travel and do not buy an issue there are lots of dry runs in the bond business that is charged against our Bond Reserve and then made up when we do succeed in buying an issue. We will credit a certain amount of the gross profit in that deal to our Bond Reserve again."[79]

It was believed that this procedure enabled the firm to approximate its profits from its bond business on an annual basis. This was a unique situation and was not, in the firm's view usable for other lines of its business.

The profit and loss statements maintained by the multi-line firms were generally not broken down by types of securities but reflected the firms income sources on the basis of the firms role in the transaction that generated the income such as, agent, principal or underwriter.

Certain further subdivisions by market place e.g. NYSE, Amex and by "product" within the "principal" category were found at E.F. Hutton. The expense items, however, were not segregated (except at Southwick, Campbell & Waterman) as to type of security or type of transaction. They were listed in the traditional categories of "salaries", "travel", "telephone", etc.

B. Attempts to Identify Certain Costs

1. Transaction Approach to Costs

At each of the firms that sold substantial amounts of securities beside fund shares, we requested a step by step description of the office procedures involved in handling a typical buy order for 100 shares of a NYSE listed stock, an OTC stock in which the firm had no position, and an outright purchase of a mutual fund. We hoped in this manner to identify some of the differences in internal office costs attributable to these classes of securities as opposed to general overhead, research, advertising, and sales expenses.

a. NYSE vs. OTC Stocks

In the NYSE member firms, the procedures for executing an order for listed and OTC stocks appeared to be fairly identical except that instead of the order going by wire to the firms' New York office and then by telephone to the Exchange floor, the firms' OTC traders "shopped" the market for the best offer a procedure described to us as taking, on the average, about one minute. The costs of direct wires from the member firms to the large OTC trading firms were generally shared equally. After enumerating the procedures of writing up order tickets, transmitting them to order clerks, etc., a typical comment was made at Dean Witter, where we were told the "...steps are all just about identical."[80]

Similar internal execution patterns obtained for the non-member and regional-only members, with respect to NYSE and OTC stocks but in the case of the non-member and regional-only members the purchasing of NYSE listed securities often exhibited a different pattern in the selection of the market place of potential and actual execution, from the NYSE members.

The responses received at Southwick, Campbell & Waterman, a non-member and Pacific Northwest, a regional-only member, illustrate two approaches to executing an order for a NYSE listed stock.

"We may check and see if this order that is received is an issue traded off the board, and if it is, and if we can get an execution pretty much comparable to the New York Stock Exchange... and [if] we could not get a comparable execution off the board, then we would put that execution on the board through one of, probably of the local branch offices of a member firm, and probably 80 percent of the time when that order is executed on the New York Stock Exchange, we wouldn't make any additional charge... in other words, what we are doing in many cases in listed issues is rendering a service to our clients at a cost the same as they would receive from a member of the New York Stock Exchange. This is simply a competitive proposition and we do it because we want to keep that client bringing all of his business to us and we will make a profit, we presume, on other business that we will do with them as we go along."[81]

This firm had no arrangement with any NYSE member whereby they would receive OTC or reciprocal business through the regional exchanges which allow payments to NASD members.[82]

At Pacific Northwest, a member of the MSE, we found that on a similar order the third market offerings were not explored at all but that the order for a stock that was not dually listed on the MSE was always pieced with A.G. Becker, a NYSE member[83] under an arrangement whereby Becker would reciprocate by giving Pacific Northwest 50% of the volume orders received in MSE business.

Ed Pocock, the firm's Treasurer, said that Pacific Northwest has never joined the PCE because "The mechanical arrangement in the Midwest with A.G. Becker just happens to be better."[84]

b. Mutual Funds vs. NYSE and OTC Stocks

The procedures among the dealers for executing and recording fund share orders were more varied than those found in the handling of NYSE and OTC stocks.

On one hand, the NYSE members generally pointed out that the execution of fund share orders was not as easy to handle as executions involving other securities because of the variety of plans, withdrawal privileges, letters of intent, and other options being offered by the funds. A significant percentage of orders were said to require a telephone call to the fund's principal underwriter to clarify or verify the terms of the purchase. On the other hand, several firms indicated that perhaps two or three fewer operations were involved in executing a fund buy order than an OTC order because in buying a fund the firm's trader would not have to check several markets.

Aside from the procedural operations involved in executing a fund order, E.F. Hutton, Dean Witter and Southwick, Campbell & Waterman emphasized that the bookkeeping operations needed to serve a fund-owning client were generally more time consuming than required for servicing a "regular" customer account. Joslyn H. Waterman, in charge of mutual funds at Southwick, Campbell & Waterman, explained why he believed his firm's fund business costs more to handle than its other business.

"...maybe we are in too much detail in some respects, but our whole concept in dealing in mutual funds, and I have been in them, now, for twenty years, has been that we are trying to maintain an investment program for the average person... we make up what we call a breakdown record, and we have gone back over a twenty year period in our most active accounts where they have accumulated mutual fund shares, and we try to balance it out as to the economic condition as at the time the purchase is made, so we have the expense of maintaining those records. We also have the expense of maintaining reinvestment and level payment records that we have taken upon ourselves to have a record for our clientele... the third thing that we have done that might be different from many dealers, and that is we try to keep an annual record of tax gain or loss for our clientele so that if any transactions take place and the plus or minus shows up, we have that record at the end of the year... our expense probably is greater than the average dealer..."[85]

In handling the three types of stocks at this firm the office procedures are very similar. Fund orders are placed with the local office of Harris, Upham, which acts as the local order-taking agent in Seattle for the principal underwriters of Keystone, Putnam, Wellington and other large eastern funds. The cost of the firm's direct wire to Harris, Upham is paid for by Harris, Upham, which in turn, receives portfolio brokerage from those funds whose orders they transmit. On large or special orders, Southwick, Campbell & Waterman places collect telephone calls to the funds' principal underwriter.

First California Company, as associate member of the Amex and a member of the MSE and PCX, had a similar arrangement with Gregory & Sons, a NYSE member firm located in New York. The costs of the wire are paid for by Gregory but there is an understanding that a certain amount of NYSE brokerage will be placed through them. About 60% of the firms' fund orders are transmitted directly to the fund underwriters generally by collect teletype. Pacific Northwest, Mutual Fund Associates and California Investors had similar arrangements with local NYSE members. The NYSE members used their own wires to their New York offices which in turn place the fund orders. The expense of using their own wire is reflected in the lower sales commission rates paid by the NYSE members to their representatives in western offices.[86]

2. Opinions as to Costs of Fund Share Handling and Profitability Additional Factors

Opinion was mixed as to the overall costs and profitability of mutual funds retailing when such cost factors as salesmen's and supervisor's time, commissions and salaries are added to the expense picture. Among the NYSE members there was no disagreement. One firm, Mitchum, Jones & Templeton, attempted to create a profitable specialized fund retailing subsidiary but the venture, though well planned and financed ended in failure.[87] At Dean Witter the partner in charge of mutual funds and unlisted stocks believed that the firm's fund business particularly large orders should be more aggressively pursued in order to gain a large percentage of what he believed to be the most profitable line of merchandise among his firm's fund, listed and OTC business. He explained that:

"...when I see how much is being sold in California and how small our percentage is I think we are passing up business that is available. I am not talking about the small amounts. I am talking about these ten or fifty or a hundred [thousand dollar orders]. We have lost ten in the last year... There are these pension funds that are buying trusts. [There are] quite a few attorneys that handle estates that find it much simpler to have trusts than to have 40 or 50 stocks that they have to keep track of the records of the dividends as, also, the fact that they can get out. If they buy in that amount, the load is very, very low, and that is the only thing I would like to stress, and I have not been able to convince some of my partners even of that."[88]

a. Additional "Back-Office" Costs

Murray Ward, Senior Vice President of E.F. Hutton believed that because his firm for many years had functioned as a commission house equipped for and dealing, for the most part, in big board stocks, the handling of mutual fund orders was generally more troublesome and possibly more expensive. Hutton's underwriting and mutual fund business was added comparatively recently to attract and hold customers.

"...we went into it because we found that these customers if they said they wanted to buy this stock and if we didn't have it, all they would have to do is go across the street and buy it. We had to go into the underwriting business to protect ourselves... To a certain extent the mutual fund thing is the same. People come to use and say 'What about this mutual fund?' They say 'Should I buy this?' We do all this horrendous bookkeeping to keep up with the thing...

“The funds are the biggest pains that we have; the bookkeeping on these funds is incredible. The amount of bookkeeping needed on especially on these plans where a person puts in $100 month or whatever it might be we have to keep a whole staff of people in the regional office trying to keep track of those things keeping track of this fund business that you are talking about is the worst headache that we have by far.”[89]

He also said that the most profitable aspect of E.F. Hutton's business was listed brokerage and noted that the cost of running the firm's computers which handle a great majority of the firms bookkeeping chores were higher in the case of fund than in listed or OTC orders because of additional hand operations required in preparing many cards for the machines.

b. Additional Sales Costs

With respect to the sales element in the total cost picture, Mr. Ward said:

“Really, though, we are leaving out one of the basic differences. Believe me, it is a whole lot easier to sell General Motors than to sell MIT ... There is a great deal more time involved in the sales of mutual funds than in the sales of a normal security.”[90]

To the extent that only additional salesmen's time is involved, it may not be considered as an additional expense of the dealer. However, the additional time required to effect fund sales may be viewed as a loss to the dealer of potential income that could be realized if the salesmen's time were spent in seeking listed business.

A similar view as to the relative costs of listed, OTC, and fund business was expressed at Mitchum, Jones & Templeton, based in part, on the fact that the handling of fund accumulation plans and other withdrawal options requires more bookkeeping than any other securities. It was also thought that although a normal OTC execution may involve “shopping the market”, it did not cost the firm more than a fund execution.

“... the over-the-counter trading desk is there, it knows the market and it is geared to them so that in a few seconds a trader can sell [or buy] over-the-counter securities whereas a fund requires more although, you know where to go. There is more formality to it and it involves correspondence in many cases.”[91]

Richard Jones, President, and Carl Gebhard, Vice-President and Secretary, of the firm said that the fund selling costs are higher than those of other types of security merchandise.

A unique experiment in the distribution of mutual funds was attempted by Mitchum, Jones & Templeton. A wholly owned subsidiary was acquired for the purpose of creating a specialized mutual fund retail firm, to operate under the aegis of a NYSE member, with its salesmen full-time registered representatives of the member firm. Mr. Jones discussed some of the problems involved:

“Mr. Jones: ... We bought a mutual fund selling organization and I thought that if we could bring the proven selling techniques of direct sales forces under the banner and control and prestige of the New York Stock Exchange, that we could gain this huge mutual fund market of California and we would 'own the world! ...In just those two years we found it was costing us -one of the great mistakes in judgment we made was the costs. It cost us a terrific amount to bring a man in off the street and put him in the mutual fund salesmen's position ... You had to fully register these people. It was around $8,000 and we found that our casualty rate was just something like the life insurance business. You have got 30 percent coming and 30 percent going. You are lucky if 40 percent stay. The turnover is fantastic.

“Mr. Lehr: Was it your thought to prepare this subsidiary as a sales organization for a fund that you might sponsor?

“Mr. Jones: I suppose at one time that might have been our dream. We didn't get close to this aspect of it. I think we had seen what others had done with successful mutual fund departments and I thought we felt that anyone that could be really successful in creating a mutual fund volume would build up a very healthy business... I would say that this was an idealistic concept that turned out to be an utter failure possibly because there are not the profit margins in the business. There wasn't under the New York Stock Exchange, and I don't know currently. IDS, I am sure, is making money in this market because they are established.

‘In my opinion it would be virtually impossible for a group to be started to concentrate in the sales of mutual funds with the current profit margin.

‘Mr. Gebhart: With or without a member firm's backing? In other words, for a member firm to try to do a job with a mutual fund division or just a firm starting from scratch?

‘Mr. Jones: Either one.”[92]

C. Profitability -A Pilot Sampling

Because of dealers did not maintain cost figures on a segregated basis by the type of securities sold, we requested that data be furnished in accordance with work sheets presented to the retail dealers, which, among other things, called for the firm's or branch office's sources of income, sales volume, dealer concession, reciprocity received and salesmen's commissions paid by type of security sold.

It should be emphasized that the following interpretations of the information furnished are at most merely suggestive of industry patterns, but serve as a useful check upon the previously expressed opinions of the individuals interviewed and indicate the scarcity of available cost and volume data maintained by retail dealers.[93]

1. Dealer's Return on the Fund Component of its Business

Although failure to allocate expenses by the firms surveyed prevents a conclusive determination of relative profitability of fund, listed, and OTC business, a comparison of the net return on the fund business among the different types of firms was possible.

By expressing “net return”, (consisting of three components: gross dealer concessions and net reciprocity[94] received, less salesmen's commissions paid) as a percent of total fund sales for the period, one element of the retailers' profit picture may be obtained.[95]

Chart I discloses that the net return on mutual fund sales was highest for the NYSE member firms as a group and lowest for the non-member firms. However, E.F. Hutton ranked fifth from the top. The range was from 1.94% (Southwick, Campbell & Waterman) to 6.6% (Mitchum, Jones & Templeton). Of the three factors comprising net return, gross dealer concession (expressed as a percent of sales) ranged from 6.39% for Mutual Fund Associates to 4.87% for Dean Witter, but there was no significant variation between NYSE members and non-member firms.

In studying the salesmen's commissions paid component (expressed as a percent of dollar volume of fund sales) that went into net return we note a range from a low of 2.34% (E.F. Hutton) to a high of 3.81% (California Investors). Lower sales commission costs were incurred by the NYSE members, averaging for the three members 2.66%. The average for all other firms was 3.24%, a difference of 18%.

The net reciprocity factor displayed the widest range: from 0.46% (E.F. Hutton) to 3.54% (Mitchum, Jones & Templeton), but was higher for NYSE member firms than for non-member firms, averaging 1.91% compared with 1.30%, a difference of 32%

The factors accounting for this expected result as to reciprocity may be attributable to the dominance of the NYSE as the market price for fund transactions, that exchange's minimum rate structure, and the NYSE member's ability to furnish research and statistical services to the funds.[96] Thus, the NYSE members by receiving a relatively higher rate of reciprocal business and paying to salesmen a relatively lower rate of commissions than the other firms are potentially able to earn greater profits on their fund business.[97]

2. Dealers' Profit Margins on Gross Income Relation to Fund Business

Chart II indicates that firm profit margins (ratio of net income to all gross income) was higher for NYSE member firms than non-member firms. The two regional-only firms had higher profit margins than the four non-member firms with the exception of Southwick, Campbell & Waterman.[98] The average for the three member firms was 9.6%

as opposed to an average loss of 0.2% for all other firms. With the exception of Southwick, Campbell & Waterman, which showed a profit margin of 11.6%, the non-NYSE member firms showed profit margins below those of any of the member firms.[99] California Investors and Mutual Fund Associates, the specialty houses lost money.

The extent on the correlation between the firm's net profit margin and its net return on mutual funds is shown on Chart III. With the exception of Southwick, Campbell & Waterman, overall firm profit margins tend to vary directly with the net return on mutual fund business.

Chart IV which relates firm profit margins to the effective rates of commission paid on fund sales shows that the firms having the highest payout ratio were losing money and those with the lowest payout ratio had the highest overall profit margin, with the exception again of Southwick, Campbell & Waterman.

The NYSE members as a group exhibited both the highest firm profit margins, and also the highest profit margins in fund business. No casual connection appears warranted, however, because the fund business at the NYSE-member firms was relatively insignificant (e.g. 4-1/2% of total commissions at Dean Witter and an average of 4.1% for the three firms.).[100] Furthermore, we must note another positive correlation between the relatively high percent of agency commission business done by the NYSE member firms and their overall profit margins.[101] Lastly, we must note that firm profit margins may be affected by volume. Even if two firms sell the same proportion of fund, listed and OTC securities, the one with the larger sales volume may exhibit a higher profit margin.

Chart I

INCOME ON SALES OF MUTUAL FUNDS AS PERCENT OF DOLLAR SALES

(Generally For Six Months Ending June 30, 1963 Ranked By Net Return)

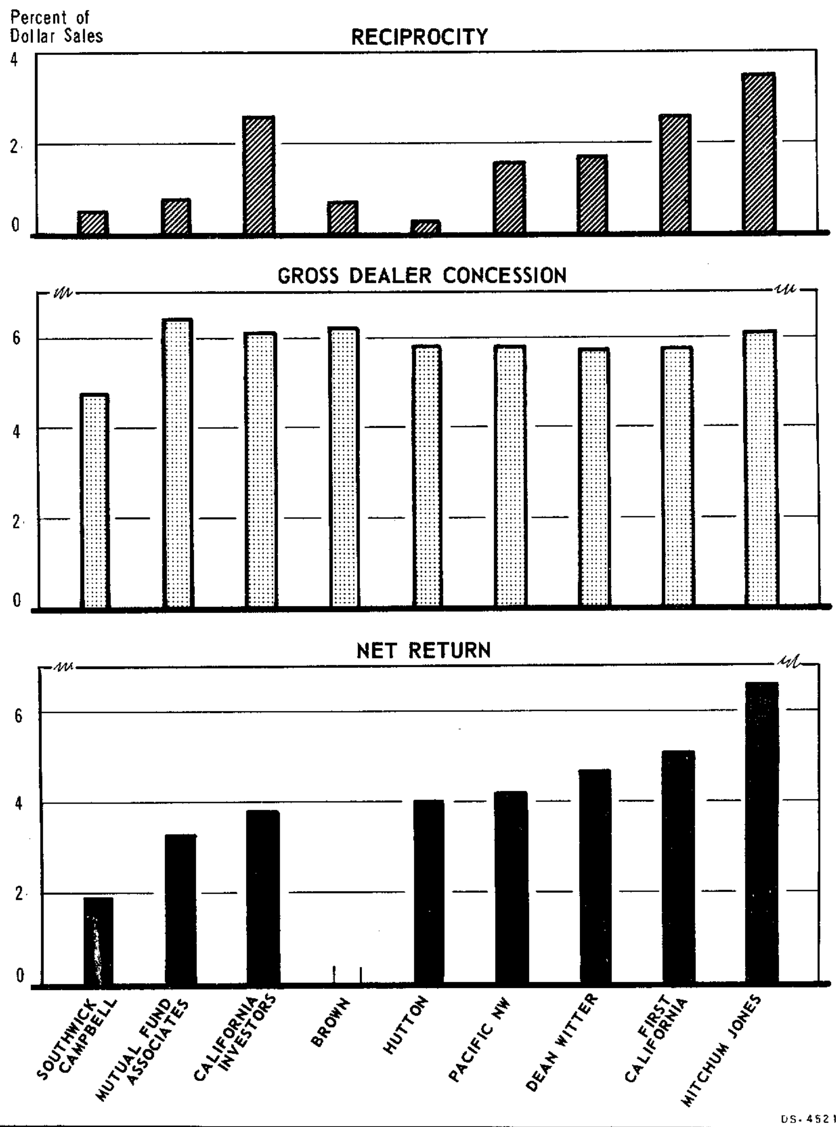
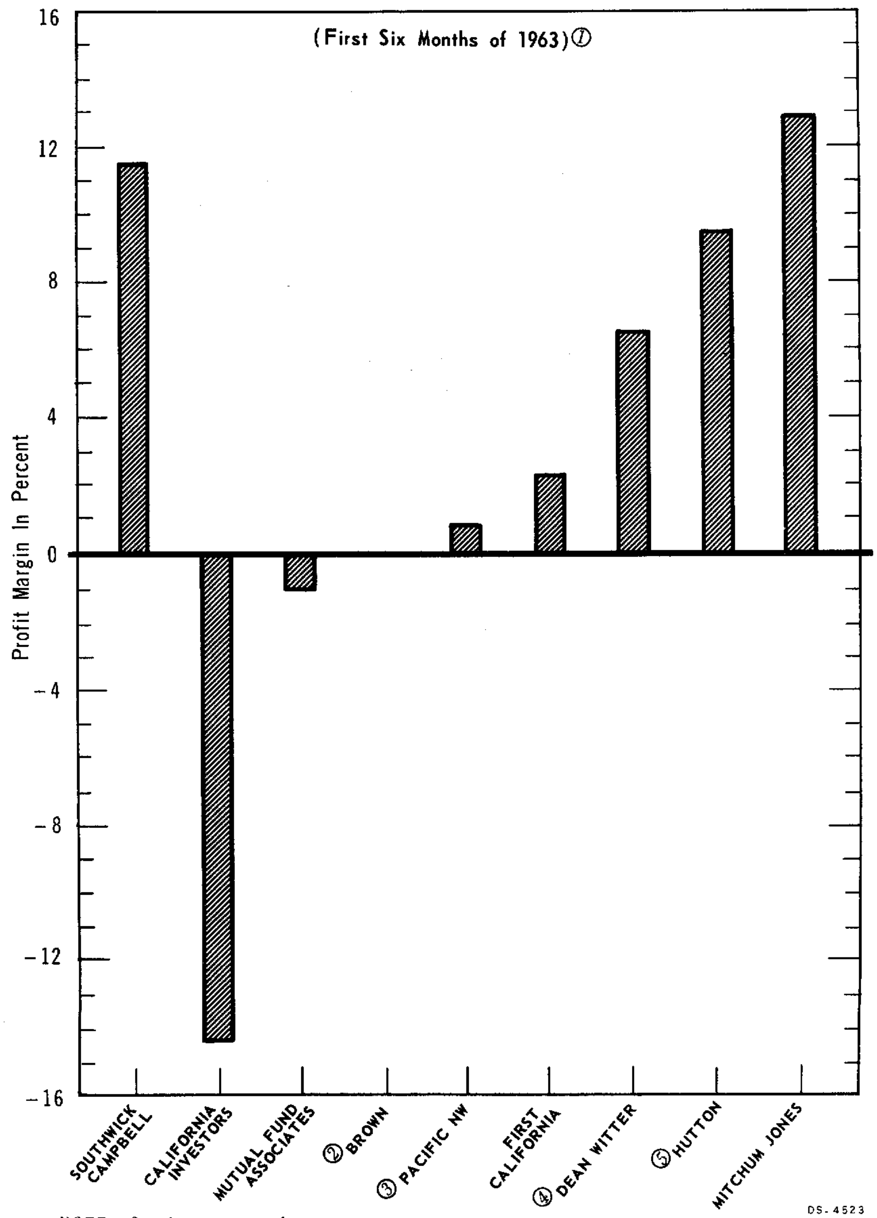


Chart II

NET PROFIT MARGINS AS A PERCENT OF GROSS INCOME



NOTE: See footnotes on the next page.

NOTES TO CHART II

1. Time Period was other than first 6 months of 1963 for the following firms:

Southwick Campbell etc.	year end 9-30-62
Pacific NW	year end 12-31-63
First California	6 mos. end 7-31-63

2. No profit margin was computed for Brown as no salary had been deducted.

3. Figure includes management fee on Equity Fund. Without this fee and assigned expenses the profit would have been a loss of 6.0%.

4. Includes interest on customer accounts which was 108% of net profit.

5. Includes interest on customer's accounts which amounts to over 66% of net income.

Chart III

FIRM PROFIT MARGIN COMPARED TO NET RETURN ON MUTUAL FUNDS

(Expressed as a percent of gross income and percent return on fund volume)

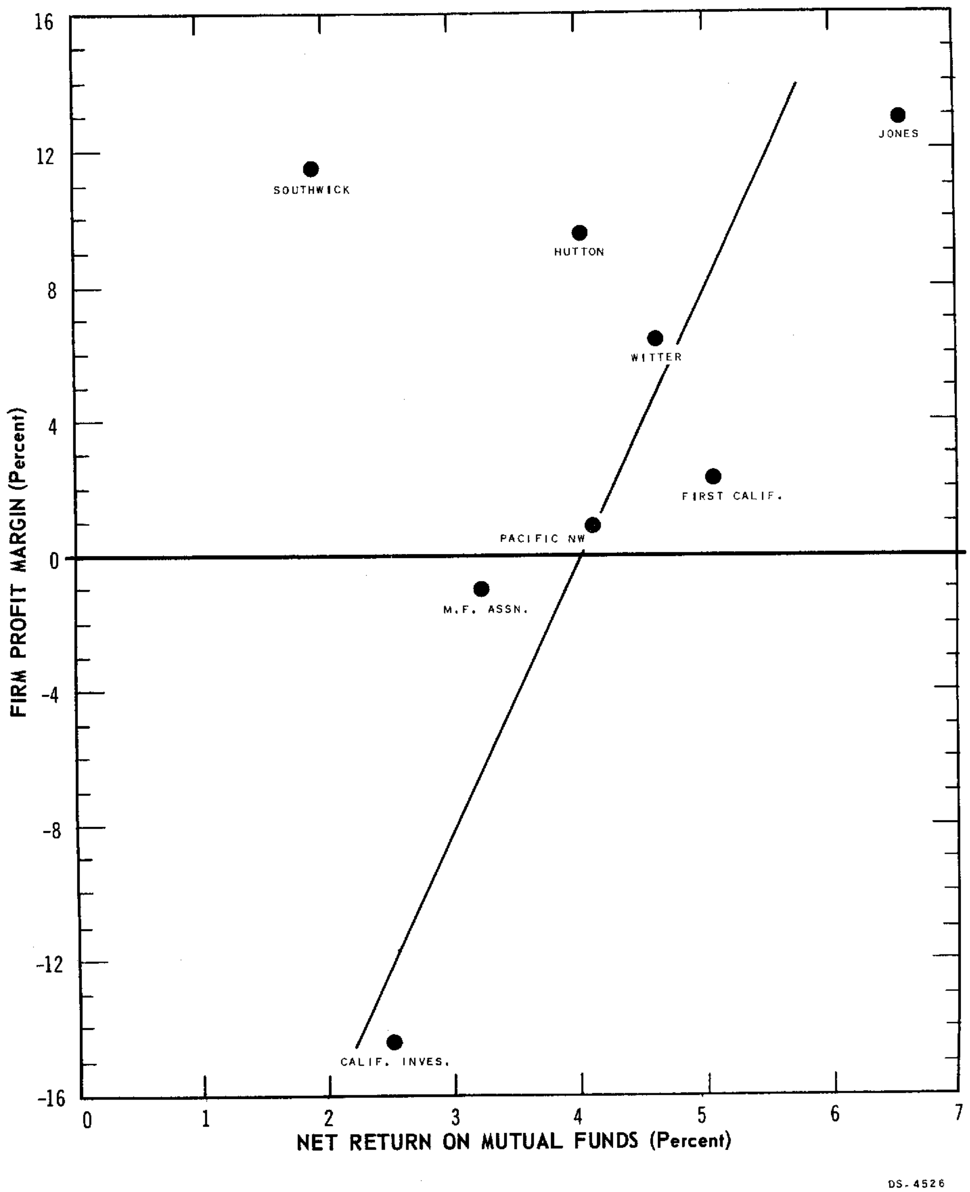
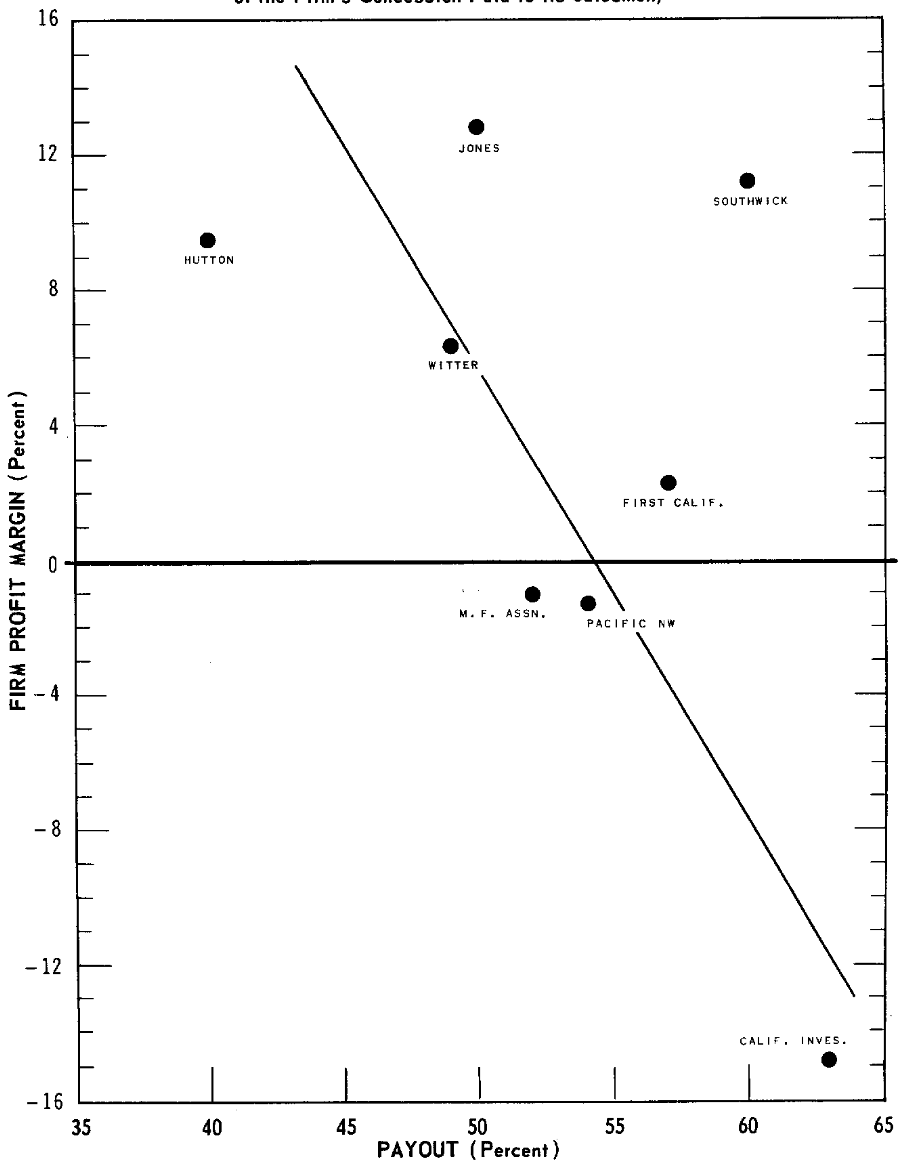


Chart IV

FIRM PROFIT MARGINS COMPARED TO PERCENT PAYOUT OF MUTUAL FUND COMMISSIONS

(Payout is Expressed as the Effective Percentage Rate of the Firm's Concession Paid to its Salesmen)



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III. Which Funds Are Chosen For Sale? The Use of "Selected Lists"

A. Background The Findings of the Wharton School and the Special Study

Any discussion of the use of "selected lists" by fund retailers is intimately bound up with the operation of reciprocal business in the fund industry. Although not all fund brokerage is given in return for fund retailing indeed some funds with captive sales forces obviously give no reciprocal for fund sales it appears that brokerage is directed, in most cases, in recognition of retailing efforts.

Chapter XI, of the Special Study of Securities Markets, dealt with reciprocal business practices in the mutual fund area.[102] It observed that reciprocal practices, though common to other businesses, gave rise to "certain unique features and problems of conflicting interests" peculiar to the fund industry.[103]

The Wharton School Study also contained discussion and quantitative analyses of reciprocity which indicated that allocations of fund brokerage were principally directed to firms serving as retailers of fund shares,[104] and that the extent of such allocations generally bore some relationship to the volume of sales attained by the firm

"A substantial number of companies report the use of various types of rules of thumb in allocating their brokerage to dealers (and sometimes also to others). The most frequently mentioned rule is that used by the management of one major system, which attempts to allocate its brokerage so that commissions roughly approximate 1% of the gross amount of its shares sold by various broker-dealers over a period of years."[105]

Fund prospectuses typically reflect such considerations.

"Although it has no commitment to do so, the Fund, when buying and selling securities, may place such business directly or indirectly with dealers on the basis of their relative sales of shares of the Fund, but only if such placement is practicable and consistent with the Fund's endeavor to obtain the most favorable prices in its investment transactions."[106]

These understandings are sometimes embodied in the principal underwriter's contract with the fund. One such agreement states that the Fund

"...will, at the request of the underwriter, place a reasonable proportion of its brokerage business with such brokerage firms as the underwriter may designate..."[107]

Eugene J. Habas, then Senior-Vice President of Hugh W. Long & Co., a major fund underwriter, told the staff of the Special Study that the practice of allocating Fund brokerage according to services rendered to the fund complex was "universal", a fact borne out by information available to the Special Study and confirmed by the findings of the Wharton Report.[108]

Reciprocal ratios do not appear in sales agreements, but responses to the Special Study's institutional questionnaire IN-4 indicates the existence of ratios of $1 of brokerage business for each $1 of fund share sales. Rations of 2:1 also appear,[109] as do some higher rations e.g. (5:1) resulting from special efforts to stimulate sales.[110]

The study notes:

"...the regular allocation of brokerage business or payment of give-ups has come to be expected by retailers of fund shares as additional compensation for their sales services. The partner in charge of mutual fund sales at Bache & Co., for example, advised the Special Study that he regards his firm as entitled to its fair share of fund portfolio brokerage, and that when reciprocal business is not forthcoming he communicates with fund management, with the usual results of obtaining an appropriate allocation. In testimony at the Study's public hearings, the Long executive quoted above stated:

"I would say that our box is always full of requests from deserving people not to forget them in terms of reciprocal..."[111]

Mr. Habas testified further:

"The Presiding Officer: If you did not provide the give ups, could you compete with some other fund or distributor that did provide the give ups?

"Witness Habas: In some instances we could not. We have learned, though, as people have in other businesses, that mere money won't buy permanent, sound relationships, so we try not to compete for the interest of the firms which may have advanced ideas on this subject...

"Q. Mr. Habas, just so there is no confusion about this, would you describe the practice in connection with the reciprocal business that you are now outlining to us and generally throughout the mutual fund industry?

"A. Mr. Berlack gave me a better word than I was going to use myself. He said it is universal and this is completely true to my knowledge...

"Q. If I understood your answers to the presiding officer's questions, do you feel that a broker-dealer who was receiving give up business with respect to certain funds would be likely to push those funds ahead of other funds from which he is not receiving such?

"A. It would be a strange situation, if I may say, Mr. Paul for him to not receive reciprocal from any sponsor with which he does business..."[112]

In the following discussion it may be helpful to think of the retailers' use of "selected lists" as but one aspect of the pressure for reciprocal rewards brought upon the funds by the independent retailers.

B. Firms Surveyed

The first exploration of the role played by the "selected list" in the sale of fund shares occurred during the Staff's interviews at Bache & Co. during January, 1962. These interviews were part of the Special Study's investigation of qualifications and training of securities dealers and salesmen, and the selling practices employed in the sale of securities generally and fund shares in particular.[113]

In order to obtain a more complete picture of the use of selected lists further interviews were conducted in New York during March, 1963 with eight NYSE member firms which were known to be active in the sale of fund shares,[114] and with the nine West Coast firms in August 1963, previously described in this report.

C. Selected Lists General Characteristics

Selected lists vary in form and consequence from firm to firm. In some instances a physical list will be issued to salesmen with order to concentrate only on list funds. Severe restrictions are placed on the sale of funds not on that list. In other cases the list becomes a "preferred list", by virtue of an announcement by the firm that certain funds are considered "sound", but no restriction is placed on the sale of non-list funds. In some cases there is no list as such, but more subtle means are used to "guide" salesmen to sell the funds chosen by the firm.

What, then, is a selected list? What forms does it take? How is such a list used and what pressures are used to assure the desired selection by salesmen? Some general finds are included here and are followed by discussions of specific practices.

The immediate purpose of the selected list is to channel fund sales efforts towards a predetermined list of funds, usually 15-30, divided among a number of fund groups. The list usually includes funds with various investment objectives and characteristics (e.g. balanced, common stock, income). This list, generally issued by a firm's mutual fund department, endorses with somewhat varying degrees of strength, the chosen funds as those in which the firm management would like to see sales efforts concentrated. Various mechanisms are employed by the firm to, either force the salesman, or make it more attractive for him to sell the selected funds rather than others. In addition to direct restrictions by the retail firm, it may pass on to its salesman a fund's periodic raised dealer concession, institute contests or place other pressures upon the salesmen to sell preselected funds. Some retailers will allow salesmen to share in the reciprocal business received from the selected list funds.[115]

There are several reasons given by the retailing firms for narrowing the range of funds they will offer to investors. There are well over 150 funds which the average firm could retail. Many firms state that an offering of all available funds without some restriction is just impractical, since a salesman could not possibly be as familiar as he should be with all the different funds' characteristics, plans and services. Some form of preselection facilitates more effect sales presentation and is safer for the investor since the firm presumably carefully selects a limited number of funds with sufficiently varied characteristics to meet all types of investor needs.

Preselection, so the argument continues, narrows the field to a manageable group and does not confuse the salesman or the investor with the relatively unimportant variances among myriad funds. It permits the firm to explore the performance record of the fund, assess its management, become familiar with its wholesaling organization, and otherwise assure itself of the soundness of the fund. Since enough funds are on the list to permit a meaningful choice of investment policy many firms feel that some form of preselection is desirable from both the firms' and the investors' point of view. So far as the argument goes, it has considerable merit.

Convenience and the interest of investors is not, however, the only reason for the existence of selected lists. It seems to be generally "understood" that funds privileged to be on the large retailing firms' selected lists will execute portfolio transactions through these retailing firms or execute transactions for the credit of such firms through other brokers.[116] Retailers have varying ideas of what the reciprocity ratio should be, but whether 1:1 or 4:1, it is generally referred to as "a fair share" of the funds brokerage business. To ensure that its "fair share" is received the retailing firm will often apply various pressures to the fund's management. Typically the retailer will call or write the fund management indicating that reciprocal business has fallen short of the expected level and expressing confidence that the fund managers will not forget the retailer in the future.

Since fund managements expand great efforts to spur sales, and since inclusion on selected lists is often the key to expanded sales volume, retention of the fund on retailers' selected lists become a matter of more than ordinary importance.

The firms using selected lists often do 50% of more of their fund share volume in shares of funds on their lists. Since encouragement to concentrate sales efforts on these funds often takes the form of extra compensation, sales campaigns and sometimes outright prohibition on sale of non-list funds, the incentive to remain on the list varies directly with the desire of the fund management to see its fund sales rise.

1. <u>Reinforcement of the Dealer's Selection</u>

Inclusion on the selected list often means direct access to individual salesmen for fund wholesalers.[117] Such access gives the wholesaler an opportunity to encourage sales of his funds by direct persuasion and affords him the opportunity to build personal loyalties within a selling organization.

Prospectuses, order blanks, and other sales material of the selected list funds are often used as the basis for training new salesmen. This privilege is highly valued since salesmen will tend to sell the funds with which they are most familiar. If training materials are limited to one group of funds the salesman goes out into the selling world "feeling comfortable" with just that group.

Lectures and sales meetings are usually conducted only by representatives of the selected list funds, thus keeping the list fund constantly before the sales force -a significant form of selling contact.

The retailer will in many cases distribute daily and monthly pricing information only on selected list funds, stock only list fund prospectuses and selling material, and in other ways restrict or edit the flow of information so that the salesman constantly has before him information only on the list funds. Further, branch managers and supervisors in their day to day contact with salesmen may constantly suggest or pressure salesmen towards the list funds. Lastly, higher effective rates of commission (in dollars or special incentives) may be paid on the list funds.[118]

In all, selection by the retailer of a fund upon which selling efforts will be concentrated is highly significant to fund managements seeking increased or even sustained sales volume.

In addition to performance, quality of the management staff and wholesaling organization, and satisfactory level of reciprocal business, other factors also seem to weigh in the retailers' decision to place a fund or fund group on his selected list. The first group of these factors may be classified as economically "rational" because they offer an unusual reward for including a particular fund on a selected list. The bargain-priced offering of management company stock to dealers in proportion to fund sales is an example of this type.

When Capital Shares offering stock in its management company to dealers as an incentive for sales it appears that their plan succeeded. Despite protestations that only well established and high quality funds were sold by their firms this offering of management stock seems to have resulted in Capital Shares' appearance on several firm's selected list. The funds concentration in insurance stocks is referred to by these firms as the reason for its selection. Other insurance funds seem, however, to have been ignored.

In one instance, Southwick, Campbell & Waterman, a dealer which stated that its selected list was drawn on a basis of established management, and performance alone, placed Medical Funds on its list because it offered to give the firm exclusive leads in the Seattle area developed from a fund sponsored mail campaign. The formation of selected lists are also influenced by "traditional" factors. These are factors which the dealer must consider in offering a "line" of funds which may not be necessarily advantageous to him economically. There are countervailing pressures on an economically motivated selected list.

2. Resistance in the Market Place

Certain "given" factors are encountered by the retailer in his formulation of even the weakest type of recommended or selected list. The dealer, his salesmen and their customers do not behave as perfect "economic men". As we shall see, several of the firms acknowledged that the level of reciprocity was one of the chief determining factors in selecting a fund group for their selected list or special sales effort. The influence of reciprocity and the dealer concession as determining factors in a firm's ultimate sales results was tested by ascertaining whether those funds that paid the highest dealer concessions and amounts of reciprocity on a given volume of sales constituted a greater percentage of the firm's business than funds paying lesser percentages.[119]

A test of this hypothesis in each firm or branch office revealed no clear correlation. Aside from inadequate data, several factors weigh against a direct correlation.

Public recognition of and interest in a fund, whether generated by advertisements (most effective is Dreyfus Fund's lion), general reputation for quality (most often mentioned was MIT), or the fact that the fund features investments in a special field (e.g. Century Shares an insurance fund), will often result in inclusion despite absence of a high rate of reciprocity. Vance, Sanders and Putnam were mentioned by several retailers as giving meager reciprocal returns, yet they were usually on selected lists because of customer recognition and requests.

This factor may be thought of as the phenomenon of "self-sellers" in the fund retail market. We were repeatedly told that when a salesman is approaching a customer on a particular fund and the customer mentions, for example, Dreyfus Fund as an investment in which he might have some interest, the salesmen will ordinarily modify his approach and begin expounding the virtues of Dreyfus Fund. It also appears that experienced salesmen often have their own favorite funds which may not be on the selected list, and will interest their prospects in those funds despite the slightly smaller economic reward.

Personal friendship or business connections also appear to play an important role. Relationships between fund managers and retailers grow over the years through periodic contacts at meetings, through visits and by phone. The retailer feels he "knows" the fund management and can trust them trust hem not only to be "fair" to the retailer but to manage the fund well.

Two illustrations of these "resisting" factors were encountered on the West Coast. In both firms it would have been economically advantageous to sell only the shares of an affiliated management's fund. In one case a greater portion of the load would be retained. In the other, the increased sales would redound to the retailer's "other pocket" in the form of increased management fees. By virtue of their arrangements with Putnam Management Company, Mutual Fund Associates may keep the entire sales load. Nevertheless sales of the Putnam funds represent approximately 60% of total fund sales. TO be sure, 60% in one management group evidences the effectiveness of direct financial inducement, but the remaining 40% is equally interesting as evidence of the markets resistance to the favored funds. At Pacific Northwest's similar situation was encountered with respect to the economic incentive to sell Equity Fund. The firm is not only principal underwriter but investment adviser as well so that any increase in asset size by virtue of fund share sales would be directly reflected in the size of the advisory fees. (Furthermore, the salesman's commission rate structure provides, along with other selected list funds, for the highest commission on sales of Equity Fund.) Sales of Equity Fund, however, accounted for only 50% of Pacific Northwest's fund sales.

D. <u>Specific Firm Practices</u>

The following table indicates the selected list practices followed by each of the 17 retail firms studied. Ten of the 17 firms had some form of selected list and one more was planning to adopt a selected list. Firms employing such lists are designated [A] to indicate a strict form of selected list practice, where a definite list of approved funds is used in connection with a continued program of incentives to sell these funds and restrictions are placed on the sale of other funds. Such practices seek to assure that substantially all of the firm's fund business is limited to the selected funds. Firms designated [B] employ a more permissive or moderate selected list policy. Three firms are designated with an asterisk indicating practices which less clearly fall into the selected list pattern -practices which indicate some more informal selection or guidance on the part of the retailer.

TABLE 2 – SELECTED LIST USE AND REINFORCEMENT

N/A – not applicable NI – no information * -Borderline case WS – wholesale representative N.Y. – Member, New York Stock Exchange ** -Through bonus credit on fund volume

<u>1. E. F. Hutton (N.Y.)</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes (Guidance sheet) [B]

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – Yes (some exceptions)

Training limited to selected list funds --Yes (some others)

Lectures and periodic presentation by representatives of list funds --Yes (some others)

Pricing and other information on list firms distributed to salesmen – Yes

Branch mgr or officer must approve sale of non-list fund -No

Higher commission or bonus on sale of list fund -No

Keep literature only on list funds -No

<u>2. L. Higgenson (N.Y.)</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] -No* (but guidance is given to larger more popular funds)

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal – NI

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – N/A (open policy)

Training limited to selected list funds – N/A (training is limited to MIT and Broad St.)

Lectures and periodic presentation by representatives of list funds – N/A

Pricing and other information on list firms distributed to salesmen -N/A

Branch mgr or officer must approve sale of non-list fund -N/A (no approval nec.)

Higher commission or bonus on sale of list fund -N/A

Keep literature only on list funds -N/A

<u>3. Kidder Peabody (N.Y.)</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes* (not a written list, but funds are selected) [B]

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in “fire sales”; special deals -Yes

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – Yes (some others)

Training limited to selected list funds – Yes (some others)

Lectures and periodic presentation by representatives of list funds -Yes

Pricing and other information on list firms distributed to salesmen -NI

Branch mgr or officer must approve sale of non-list fund -No

Higher commission or bonus on sale of list fund -No

Keep literature only on list funds -No

<u>4. F.I. DuPont (N.Y.)</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes (fund ideas list – gen guidance) [B]

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – Yes (some others must be approved)

Training limited to selected list funds -Yes

Lectures and periodic presentation by representatives of list funds -Yes

Pricing and other information on list firms distributed to salesmen – Yes (some others)

Branch mgr or officer must approve sale of non-list fund -No

Higher commission or bonus on sale of list fund -No

Keep literature only on list funds -No

5. E. Dillon (N.Y.)

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] -No

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -Yes

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – N/A

Training limited to selected list funds – N/A

Lectures and periodic presentation by representatives of list funds -N/A

Pricing and other information on list firms distributed to salesmen -N/A

Branch mgr or officer must approve sale of non-list fund -N/A

Higher commission or bonus on sale of list fund -N/A

Keep literature only on list funds -N/A

6. Reynolds (N.Y.)

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – No* (but some effort to narrow the field to 20 mgts is made)

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -Yes

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – N/A

Training limited to selected list funds -N/A

Lectures and periodic presentation by representatives of list funds N/A

Pricing and other information on list firms distributed to salesmen -N/A

Branch mgr or officer must approve sale of non-list fund -N/A

Higher commission or bonus on sale of list fund -N/A

Keep literature only on list funds -N/A

7. Shields (N.Y.)

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] -No

Firm official will call if level of reciprocal is not satisfactory -No

Firm participates in "fire sales"; special deals -No

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – N/A

Training limited to selected list funds -N/A

Lectures and periodic presentation by representatives of list funds -N/A

Pricing and other information on list firms distributed to salesmen – N/A

Branch mgr or officer must approve sale of non-list fund -N/A

Higher commission or bonus on sale of list fund -N/A

Keep literature only on list funds -N/A

<u>8. Bache (N.Y.)</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes (22 funds) [A]

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -NI

Salesmen share in reciprocal -Yes

Access to salesmen for selected list wholesalers -Yes

Training limited to selected list funds -Yes

Lectures and periodic presentation by representatives of list funds -Yes

Pricing and other information on list firms distributed to salesmen -Yes

Branch mgr or officer must approve sale of non-list fund -Yes

Higher commission or bonus on sale of list fund -No

Keep literature only on list funds -No

9. Ferris (N.Y.)

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes (12 fund grps) [A]

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in “fire sales”; special deals -Yes

Participated in Capital Shares Mgt. stock deal – Yes (but rec’d no stock)

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – Must go through partner in charge others come occasionally

Training limited to selected list funds -Yes

Lectures and periodic presentation by representatives of list funds -Yes

Pricing and other information on list firms distributed to salesmen -Yes

Branch mgr or officer must approve sale of non-list fund – No (ptnr. in chg will raise if too many non-list sold)

Higher commission or bonus on sale of list fund -No

Keep literature only on list funds -Yes

10. Pacific NW Co.

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes (31 funds; 15 mgts) [A]

Firm official will call if level of reciprocal is not satisfactory – Yes (will not include firm on list if no reciprocal)

Firm participates in “fire sales”; special deals -Yes

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal – Yes**

Access to salesmen for selected list wholesalers – Yes (some others)

Training limited to selected list funds -NI

Lectures and periodic presentation by representatives of list funds -Yes (some others)

Pricing and other information on list firms distributed to salesmen -NI

Branch mgr or officer must approve sale of non-list fund -Yes

Higher commission or bonus on sale of list fund – Yes (bonus arrangement)

Keep literature only on list funds -No

11. Southwick

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes [21 mgts) [B]

Firm official will call if level of reciprocal is not satisfactory -Sometimes

Firm participates in “fire sales”; special deals – Yes (only Cap. Life)

Participated in Capital Shares Mgt. stock deal – Yes (principals bought heavily themselves)

Salesmen share in reciprocal – Yes**

Access to salesmen for selected list wholesalers – Yes (others too)

Training limited to selected list funds -Yes

Lectures and periodic presentation by representatives of list funds – Yes (some others)

Pricing and other information on list firms distributed to salesmen -Yes

Branch mgr or officer must approve sale of non-list fund – All sales subject to approval

Higher commission or bonus on sale of list fund -No

Keep literature only on list funds – Yes (some on others)

12. First California

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – No (but are setting up, want 10 fund list)

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -Indirectly

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – Yes (others too)

Training limited to selected list funds – Yes (proposed)

Lectures and periodic presentation by representatives of list funds – Yes (some others)

Pricing and other information on list firms distributed to salesmen – Yes (list now includes others)

Branch mgr or officer must approve sale of non-list fund -No

Higher commission or bonus on sale of list fund -Yes

Keep literature only on list funds -No

<u>13. Mutual Funds Assoc.</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes (3 mgts) [A]

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal – Yes**

Access to salesmen for selected list wholesalers – No (some doubt)

Training limited to selected list funds -Yes

Lectures and periodic presentation by representatives of list funds -Yes

Pricing and other information on list firms distributed to salesmen -NI

Branch mgr or officer must approve sale of non-list fund -No

Higher commission or bonus on sale of list fund -Yes

Keep literature only on list funds -Yes

<u>14. Dean Witter (N.Y.)</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes (20 mgts 49 funds) [B]

Firm official will call if level of reciprocal is not satisfactory -No

Firm participates in "fire sales"; special deals – Yes (not limited to SL)

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – Open door policy (up to mgr)

Training limited to selected list funds -Yes

Lectures and periodic presentation by representatives of list funds -No

Pricing and other information on list firms distributed to salesmen -Yes

Branch mgr or officer must approve sale of non-list fund -No

Higher commission or bonus on sale of list fund -Yes

Keep literature only on list funds -No

<u>15. Mitchum Jones (N.Y.)</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – Yes (5 mgts 20 funds) [B]

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes (not limited to SL)

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal -Yes

Access to salesmen for selected list wholesalers – Yes (others too)

Training limited to selected list funds – Yes (gen.)

Lectures and periodic presentation by representatives of list funds – Yes (some others)

Pricing and other information on list firms distributed to salesmen -NI

Branch mgr or officer must approve sale of non-list fund -No

Higher commission or bonus on sale of list fund -Yes

Keep literature only on list funds -No

<u>16. California Investors</u>

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] – No (though tend to do 60-75% of business in 6 funds)

Firm official will call if level of reciprocal is not satisfactory -No

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal -No

Access to salesmen for selected list wholesalers – N/A (any WS they "know")

Training limited to selected list funds – Train on Keystone

Lectures and periodic presentation by representatives of list funds – Yes (WS they know)

Pricing and other information on list firms distributed to salesmen – N/A

Branch mgr or officer must approve sale of non-list fund -N/A

Higher commission or bonus on sale of list fund -N/A

Keep literature only on list funds -N/A

17. Mary Lou Brown

Does Firm have some form of Selected List [A = Strict; B = Moderate-permissive] -No

Firm official will call if level of reciprocal is not satisfactory -Yes

Firm participates in "fire sales"; special deals -Yes

Participated in Capital Shares Mgt. stock deal -No

Salesmen share in reciprocal -N/A

Access to salesmen for selected list wholesalers -N/A

Training limited to selected list funds -N/A

Lectures and periodic presentation by representatives of list funds -N/A

Pricing and other information on list firms distributed to salesmen -N/A

Branch mgr or officer must approve sale of non-list fund -N/A

Higher commission or bonus on sale of list fund -N/A

Keep literature only on list funds -No

Eleven of the sample firms were NYSE member firms, of these 7 had some form of selected list, 4 of the 6 non-members had -or would soon have -a selected list system.

Thirteen of the 17 firms will call fund management officials if they feel reciprocal business is not at satisfactory levels. Of course, the level at which the retailer will be satisfied, where he will write a thank you letter instead of a reminder, differs from firm to firm and within firms from fund to fund, depending upon the amount of reciprocal the retailer thanks the fund management has available for distribution.[120] Generally 1-2% is expected -and often received.[121]

The NYSE member firms which offer institutional services (e.g. investment research) receive brokerage business in payment for such services separately, and will receive an additional 1-1.5% for the sale of fund shares.[122]

Almost all firms denied that they had ever threatened to drop a firm if no reciprocal, or a more satisfactory reciprocal, was not received. At Pacific Northwest Company one officer responded perhaps more candidly than some others. When asked how the firm determined which funds to place on its selected list:

"Well, let me say very frankly that we did not include any fund in there from which we felt we would not get some sort of stock exchange business and that sort of thing."[123]

Apparently others also consider reciprocal as a factor in selecting funds for their lists or for special campaigns.[124]

Mutual Fund Associates and Shields & Co. do not participate in "fire sales" where the dealer concession is raised for a designated period of time; only 4 participated in the Capital Shares deal under which retailers received management stock as an incentive to sell its fund's share.[125]

Of those firms employing selected lists access to salesmen by wholesalers and use of fund training literature served as an important method of guiding salesmen.

Only 3 firms (including Bache & Co.) went so far as to require approval when a non-list fund is sold. Another, Ferris & Co., was less strict but too many sales of non-list funds would bring inquiry from the partner in charge. Five firms of the 11 will pay a higher commission or bonus on the sale of list funds. And only a few will not stock non-list fund materials.

Only 4 of the firms gave salesmen an opportunity to share in reciprocal business, either directly or through bonus plans.[126]

More important was the dissemination by the 11 firms of an actual recommended list to salesmen and/or a periodic list of funds with pricing and other information for the “guidance” or information of salesmen. Other firm sponsored information, e.g. monthly “fund ideas” or news about selected funds, keeps salesmen aware of those funds which bear the firm's endorsement.

E.F. Hutton's “list” consists of monthly data sheets distributed to all salesmen titled “How the Funds Did Last Month.” The list contains 26 funds. 9 designated “capital growth”, 8 “income with growth”, 5 “income”, and 4 “balanced” funds. The sheet carries the legend on the reverse side that it is for “internal use only”, that the funds were chosen for a “variety of reasons including, past performance objectives, and features” and in “no way limits the funds” which may be recommended in specific situations “but rather is intended as a suggestive guide”.

In fact salesmen are urged to use the list as a guide and are pretty much told that these funds are the ones which E.F. Hutton approves for sale.[127]

Pacific Northwest Company's list was clearly defined as a selected list which was binding on the salesmen. Other funds could be sold only with managerial permission, the firm making it very clear that the list was more than merely a suggestion but a limitation on salesmen's discretion.

Ferris & Co. has a list which, although it is not an actual sheet of paper distributed to salesmen, is “communicated” to the salesmen at meetings or informally by the partner in charge.

“They pretty well know what the framework is. I am fairly liberal here. We have 10 managements and you may have one emphasizing this one and another this one, and, as long as he [the salesman] knows the management is approved... it is a general list...”[128]

Nonetheless, it is clearly a limitation on the salesmen who knows the approved managements and who also know that they will be questioned by their supervising partner if non-approved funds are sold.[129]

E. <u>Summary</u>

As has been noted at the outset the selected list system is only one aspect of the reciprocal business structure in the fund industry. The pattern of pressures arising from this structure affects the fund managers, the wholesalers and the retailers in different ways. The result of these pressures is, however, clear -each component of the food structure, except possibly the fund itself, is financially interested in continuing and expanded sales. The advisory fee which generally grows with fund asset value and the commissions from the sale of fund shares provide this sales incentives for the funds' managers and underwriters.

The NYSE's commission rate structure automatically creates a great additional source of reward -(the funds' pool of brokerage arising from portfolio transactions), for NYSE fund retailers, over and above their share of the sales load. The non-NYSE member firms, which retail a great portion of fund shares, have sought ways to tap the funds' brokerage pool with varying, though limited, degrees of success. These “less privileged” fund retailers have in no uncertain terms demanded their share of the commission dollar which was so generously being given to their NYSE rivals. The funds have facilitated the efforts of the non-members by seeking arrangements with NYSE firms which would channel business of services to the non-members. The funds' lever on the NYSE firms is a strong one -the power to channel massive amounts of listed commission (and other brokerage) business to “deserving” or “friendly” NYSE firms.

The power of the fund managers to direct brokerage and use that power to spur sales by both NYSE and non-member firms is one side of the picture. Just as the fund managers can exert pressure to sell a particular fund through judicious allocation of brokerage commissions so can large retail dealers exert pressure on fund managers for brokerage by selecting among “cooperative” or “friendly” funds. The selected list is often used as a device to pressure the fund managers into allocating brokerage to fund retailers. The effectiveness of such lists vary with the eagerness of the fund managers to expand sales. It is in this context that the selected list must be viewed.

It would be an oversimplification to require that the selection of funds for sale by retailers from the whole range of funds now being offered, must be made on the basis of performance or “suitability” for the particular investor. Clearly, the present existence of captive fund sales forces (e.g. IDS, Hamilton) indicates that selection of funds for sale by the retail entity may be based only on affiliation with the fund and its identity with the management company. In this sense an operation such as IDS presents the most select type of selected list. This aspect of the suitability question is not, however, of concern here since it is obvious that IDS' funds face no pressure to allocate any brokerage in return for the sale of fund shares. It should also be clear that the IDS limitation on its sales force to sell only its own funds does not result in a true selected list, in the sense that the term has been used here. We have applied it only to the situation where the retailer is independent of the fund and has a free choice in selecting the funds he will sell. It is the situation, where the independent retailer limits his free choice of funds by employing a selected list, and where that selection is employed primarily as a means of exacting fund portfolio commission business, as a reward for the sale of fund shares over and above the dealer concession, that dangers to the fund investor and industry arise.[130]

An industry structure in which fund managers respond to dealers' demands for additional selling rewards by channeling vast amounts of fund brokerage to such dealers, results in a situation where fund managers may be pressured to churn fund portfolios (a practice which is made even more dangerous because it is so difficult to prove or expose) and to execute transactions in markets or with firms which may not provide the fund with the best available price or service.

IV. INDUCEMENTS TO RETAILERS AND SALESMEN

This part of our discussion will examine the flow of economic rewards first, from the funds to the retailer,[131] and second, from the retail firm to its salesmen. These rewards have already been mentioned in our discussion of selected lists but are here examined in the context of specific structures found among the firms.

A. Reciprocal Business

In our discussion of profitability and selected lists, we observed the variation in the percentages of reciprocity flowing to the different categories of firms and noted the lack of positive correlation between choice of funds by the dealers and the percentage level of reciprocity they received. This section will discuss the mechanism through which reciprocity flowed to the firms in our sample.

One of the features that makes the selling of mutual fund shares unique in the securities business is that besides the retailers' commission on the sale of shares, a dealer may receive additional reciprocal income or other benefits at the direction of the funds.[132] The countervailing expenses that in part absorb (and at times exceed) this additional income are found in the generally higher salesmen's commissions paid on fund sales,[133] and generally disproportionate time it takes to effect a fund sale,[134] and in certain firms, additional "back office" costs.[135]

1. Reciprocity Structure

The main patterns of reciprocity which we encountered were: (a) receipt of give-up checks from the fund's executing brokers; (b) inclusion of the dealer in a selling group for a current underwriting at the direction of the fund and the purchases by the fund of the dealer's total allotment; (c) "courtesy" business, or, the privilege of directing the fund to place portfolio brokerage with firms designated by the dealer for which, in turn, the dealer receives certain benefits from the designated firm;[136] and (d) direct receipt of fund portfolio brokerage.

a. Variation in Reciprocity Pattern by Type of Firm

The NYSE members derived most of their reciprocity through pattern (d) portfolio brokerage, whereas the non-NYSE members were compensated primarily through patterns (a), (b) and (c).

The regional exchange members may receive reciprocity by means of all the patterns because of the securities dually listed on the NYSE and the PCE and MSE.

In practice, however, regional exchange membership was not important as a means of receiving pattern (d) reciprocity portfolio brokerage because the funds generally executed through NYSE members. But because many executing brokers are also regional exchange members, they were able to give up to the regional-member dealers by executing on the regional exchanges.

Pacific Northwest, whose arrangement respecting NYSE orders with A.G. Becker, a member of the NYSE and MSE, has previously been described,[137] requests the fund underwriters "... not to give business for our credit in New York other than through A.G. Becker because we have no way of getting it back."[138]

The arrangement between Mutual Fund Associates and Sutro & Company exemplifies pattern (c), "courtesy", reciprocity. Because it is not a member of any exchange and has no OTC trading department, Mutual Fund Associates does not receive direct portfolio executions from the funds.[139] It does request the funds whose shares it sells to direct their executions to Sutro & Company in San Francisco and to indicate that the order should be placed to the credit of Mutual Fund Associates. For this business, Sutro's research department will furnish analyses of the security holdings of Mutual Fund Associates' prospective and existing customers. We were told that Sutro does not recommend that fund shares be purchased, but analyzes a customer's holdings with regard to his investment objectives and may recommend that certain shares be sold or that further diversification would be desirable. It was estimated that Sutro does between 20 and 40 such analyses each month for Mutual Fund Associates.

2. Retailer's Reciprocity Records

Corresponding to the detailed records maintained by the underwriters, of the fund complexes that were recently studied,[140] most of the retail firms questioned, indicated that they maintained records of reciprocity received from the funds.

Although no formal understandings as to the ratio of reciprocity[141] to sales or services were reported, it was generally felt that the funds should maintain a flow of reciprocity consistent with their past performance on a comparable basis of fund portfolio turnover.[142]

These expectations, however, are not always fulfilled. At Pacific Northwest we were told that –

"... some of the funds have fallen quite a ways behind and have disappointed us, but because they are, in our opinion, such top-notch managements and because we do hope, as time goes along, that they will catch up, we have stayed with them. We have made no change in our [approval] list since it was originally formed because of the failure of anyone to come through on what we felt was a fair basis, although not everyone has so far."[143]

Only Lee Higginson and E.F. Hutton, NYSE member firms, had records of the services (viz. sales, research, pricing), for which reciprocity was received, primarily because the funds will not inform the retail firms of their own allocation. Reciprocity was furnished solely for sales in the non-NYSE-member firms because they rendered no additional services.

B. The Role of the Fund's Wholesale Representative

Opinions were unanimous as to the positive health of wholesale representatives as a group to the individual retailer's overall fund selling efforts. However, the NYSE-member and regional member firms as a group stressed the necessity of limiting the time they allowed their salesmen to attend sales meetings conducted by these representatives.[144]

1. Function

At E.F. Hutton, the primary function of the wholesaler was described as –

"... a wholesaler as in any other business. He gets out and distributes. He is a warehouse, a local warehouse distributor... he comes in the office and keeps that rack filled [with fund literature] and talks to the men who are interested in the funds... He has a place in the business like a sales warehouse has a place in the distributing industry."[145]

Wholesale representatives were relied upon by all firms to implement their sales training program, but their selection generally was from the funds on the firm's selected list.[146] At Mitchum, Jones & Templeton, in addition to office meetings, certain wholesale representatives make calls with both trainees and experienced men to help them with their sales approach. They also arrange for the salesmen to meet with their fund's management and research personnel in order to help them understand the industry and their particular fund. When asked if his firm could get along without their assistance, Mr. Jones said:

"At one time I might have thought so because of direct selling... I would change my mind. I think they do perform a function."[147]

2. Access to Salesmen

All firms except Mutual Fund Associates permitted some fund's wholesale representatives access to their salesmen, both on an individual basis and at scheduled sales meetings, which in most firms occurred about once a month.[148] A typical case is Southwick, Campbell & Waterman where the entire sales staff is addressed by some representatives about once each month. Mr. Waterman said that the representatives furnish the salesmen current information about their funds, discuss new sales ideas, and explain available services, such as, withdrawal programs or switching from one fund in a complex to another. He believed that such meetings were preferable to his gathering the current information and passing it on "second hand" to the salesmen.

However, at Mutual Fund Associates, it was explained why wholesalers are generally not given access to the salesmen.

"We used to do that, but the difficulty was each wholesaler would come along with a different story, and we would not be talking about the broader approach... In effect, he was trying to teach our salesmen to product sell one particular product."[149]

The wholesale representatives at this firm do however freely call upon its office managers who, in turn, pass on to their salesmen, information and ideas geared to their own local sales programs.

At California Investors, a middle-of-the-road policy allows the representatives access to salesmen at scheduled meetings provided the substance of the talk previously reviewed and "cleared" by the firm.

C. Dealer Inducements to Their Salesmen

The regular sales commission schedule in any firm varies in the percentage of the dealers commission paid over to the salesmen, depending upon the type of merchandise sold. These regular commission schedules also varied among the 9 firms in the specific percentages paid on any one type of security. Besides a commission, special incentives are given the salesmen to direct their efforts toward certain fund groups or the attainment of higher over-all volume in fund or non-fund sales. By combining (where possible), the regular commission rates with the dollar values of the extra incentives offered by the firms an effective rate of commission may be derived for each firm, which can be compared among the several types of firms.

In the following discussion "sales commission" refers to the amount the retail firm pays its salesmen expressed as a percent of the retail firm's spread, markup, dealer concession, or "commission",[150] received on a customer's purchase or sale of a security.

1. Effective Rates of Sales Commissions

Chart V shows salesmen's commissions expressed as a percent of the firm's dealer concession in the case of funds and dealer commission for OTC and stock exchange transactions. The salesmen's commission rates on mutual fund sales were determined by comparing the total dollars paid to salesmen by a firm with the total dollars received by the firm as dealer concessions during the period.[151] The resulting effective rates reflect the extra sales inducements such as payments of the standard rate on an assumed higher dealer concession. For example, the firm on its selected list funds may increase the dealer concession from 6% to 8% when calculating the commission. They also reflect the graduated scale of fund commissions offered in some firms. The effective rates developed do not reflect the costs of prizes or contests such as the ones held by Mutual Fund Associates, because their costs are lumped into the firm's general sales expense figures and were not reported on the work sheets as compensation to salesmen, from which our figures were derived. If we were to add in the cost factor attributable to such prizes, to the dollar amounts of commissions paid, the effective rates of commission in firms like Mutual Fund Associates and California Investors would be even higher because of the greater frequency of such incentives in those firms.[152]

Effective rates on fund sales were higher than minimum rates in all firms except one NYSE member firm[153] as a result of sliding commission scales and special incentives. These additions to the basic fund rate such as, bonus payments and credits, and awards for sales contests are described under "Special Incentives."

The most complex regular fund commission structure encountered was the sliding scale found at California Investors. In each calendar quarter, salesmen receive 50% of the dealer concession until their commissions reach $1,2000; 62% on the next sales until an additional $1,200 is earned, and 75% on any excess within the same quarter. At the start of the next quarter, the salesmen again start at 50%.

The bookkeeping to compute commissions under this system requires the full time of two employees and the part-time attention of one supervisor. It was said that "... if we had to do it again I might not do it. It is a little costly in bookkeeping we have learned."[154]

Although California Investors' salesmen do not participate directly in reciprocal income, it was pointed out that

"... possibly they might indirectly to the extent that there is some question in my mind if we could pay the commission schedule that we do if [we] weren't getting reciprocal business. There is no question in my mind in that area. Possibly we would have to reexamine the commission schedule if we didn't have any reciprocal business coming in. I would think this is in direct correlation there."[155]

The highest effective fund rate of salesmen's commission was 63% at California Investors and the lowest was 40% t E.F. Hutton. The range of the NYSE members was from 40% to 54.5% (Mitchum, Jones & Templeton), while the two regional-only members paid 55%, (Pacific Northwest) and 57% (First California). Pacific Northwest's effect rate of 55% excludes sales of Equity Fund. On sales of Equity Fund, it pays an effective rate of 91%.

Chart VI depicts the variations within each firm in payout rates on mutual funds by indicating the lowest commission, average commission, and highest possible commission rate the salesmen may be paid. The maximum rates are those paid either on sales of certain funds, on individual large sales, or on high aggregate volume. At Mutual Fund Associates, First California Company, and Mitchum, Jones & Templeton, of the 8 comparable firms,[156] sales of selected list funds were directly rewarded by higher effective rates of commission.[157] Dean Witter paid a higher than normal rate on a fund sale in excess of $100,000. Southwick, Campbell & Waterman, and California Investors reward sales efforts by paying higher rates on higher aggregate sales. E.F. Hutton may pay out an effective rate above the stated minimum, but only when the wholesaler offers a raised dealer concession.

2. Exchange Commission Rates

The Commission rates on exchange transactions very from a low of zero at Mutual Fund Associates,[158] to 15% at Pacific Northwest, up to 50% paid at 4 firms. The three NYSE members average 40% as compared with the regional-only members average rate of 50% and the non-member average of 50%.[159]

E.F. Hutton and Dean, Witter, the NYSE members interviewed which had offices throughout the country, pay lower commission rates on the West Coast than in the East. For example, Dean, Witter pays 33-1/3% on all agency business in New York, 30% in Chicago and 25% on the West Coast (up to $3,000 per transaction and 33-1/3% above that amount). The costs of wiring the transactions to the NYSE and the AMEX were said to account for this difference.

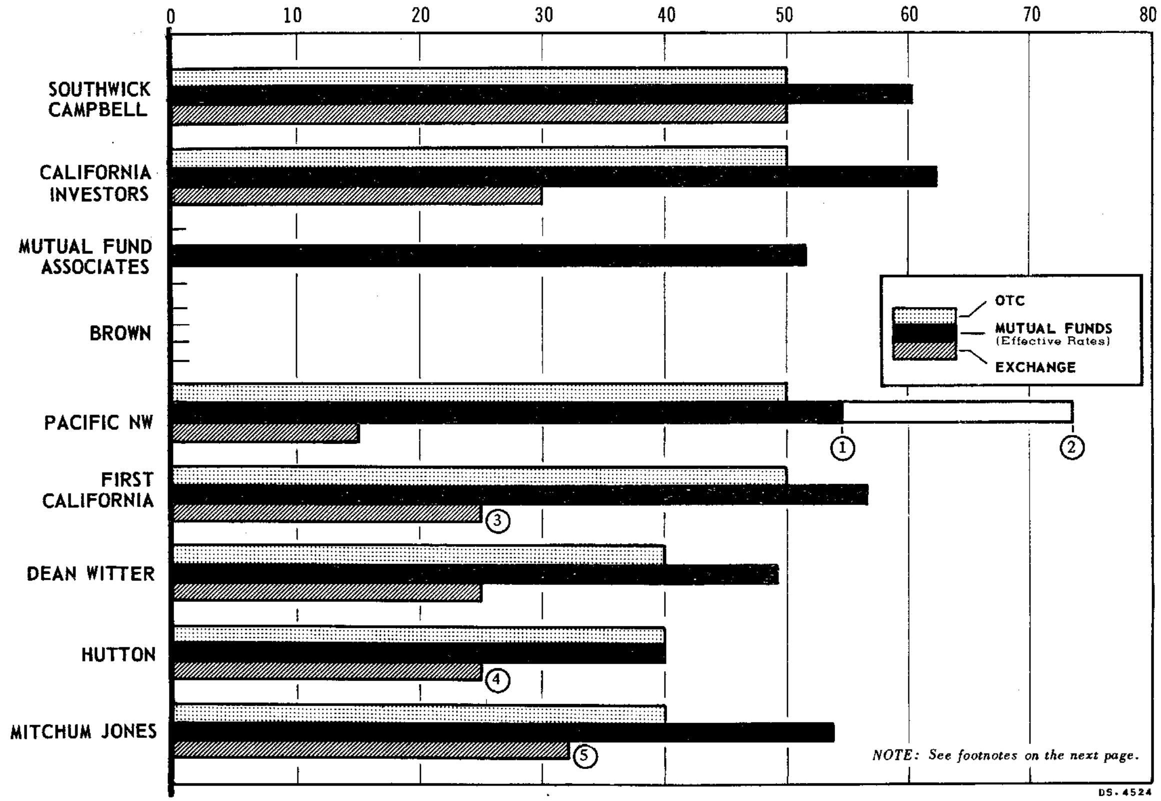
3. Special Incentives

The special incentives (summarized in Table 3) instituted by the individual firms generally are not directed toward maximizing sales of any one fund group but are ultimately geared toward increasing the firms' total fund income by channeling sales efforts toward their selected list groups.[160] Any system of fringe benefits or reciprocal credits to salesmen has been arbitrarily considered under this heading rather than as part of the firms' regular sales commission structure, although in the practical effect upon salesmen's income and the firm's expenses, they are inseparable.

Chart V

SALESMEN'S COMMISSIONS BY TYPE OF SECURITY FOR EACH FIRM

As Percent of Gross Commissions or Dealer Concessions



NOTE: See footnotes on the next page.

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NOTES TO CHART V

1. Excluding Equity Fund Sales
2. Including Equity Fund
3. First California Stock Exchange Commission Rates:

NYSE	25%
AMEX	20%
PCE	40%
MSE	25%
Other Regionals	20%

4. E. F. Hutton pays 25% for the first $25,000, 30% up to $50,000 and 35% above $50,000 on any one sale on all exchanges.
5. Mitchum Jones & Templeton pays no commission on regional exchanges other than the PCE.

Chart VI

MINIMUM, EFFECTIVE, AND MAXIMUM COMMISSION PAYOUT
for each Firm on Mutual Fund Business

Salesmen's Commissions as Percent of Dealer Concessions

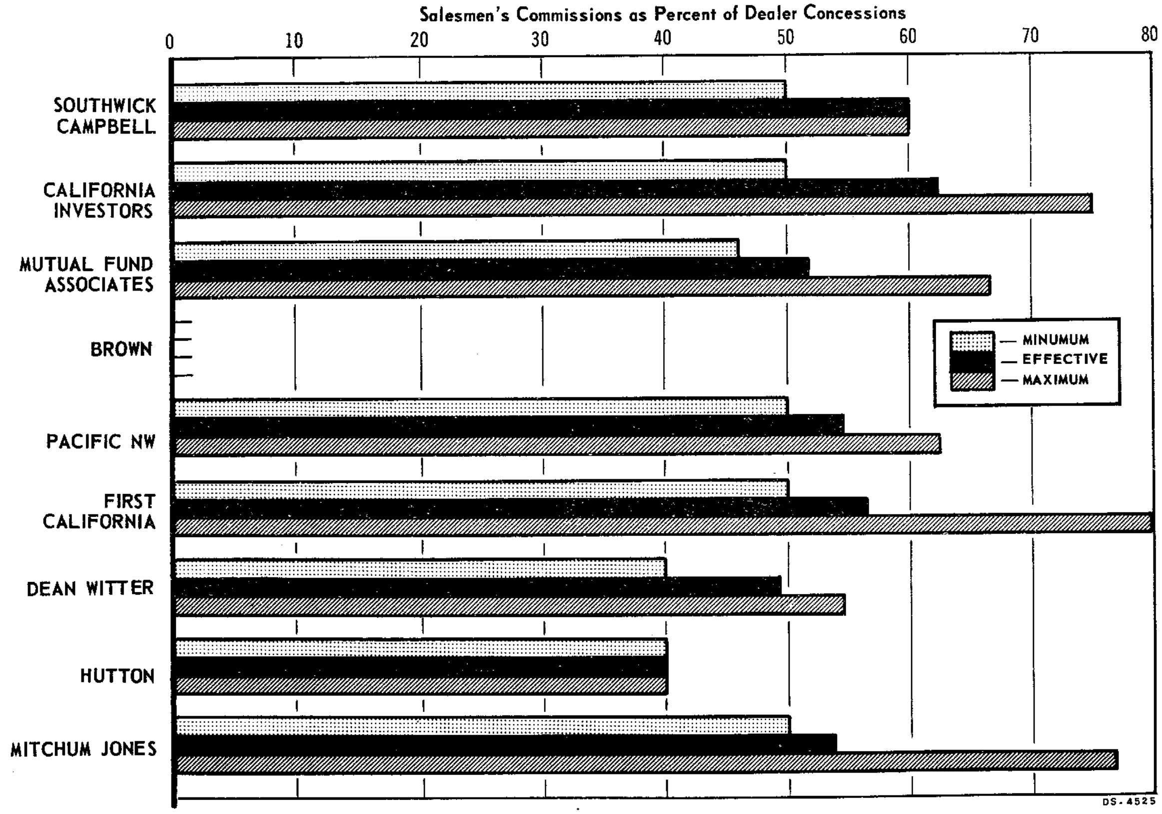


Table 3. -- Special Incentives for Mutual Fund Sales (within 3 years or presently contemplated)

	Periodic Increase in Salesmen's Rate of Commission on Several Funds	Bonus Credits Based on Fund Sales Volume	Bonus Credits Based on Reciprocity Received by Firm	Sales Contests Based on Either (i) Total Sales; (ii) New Accounts Opened; Or (iii) Percentage Increase on Sales	Trips (Awarded Sales Contests)	Firm or its Members Have Acquired Stock of Mgmt.Co.	Salesmen Share in Wholesaler's Increase in Dealer's Concession
Dean, Witter 1/							X
E. F. Hutton 1/							X
Mitchum Jones & Templeton 1/	X		X				X
Pacific Northwest 2/	X	X		X			X
First California 2/	X					X	X
Mutual Fund Associates 3/	X	X		X	X		
California Investors 3/	X			X	X		X
Southwick, Campbell & Waterman 4/		X				X	X
Mary Lou Brown 4a/	- - - No Salesmen - - -						

1/ NYSE Members.

2/ Regional Exchange Members.

3/ Mutual Fund Specialists -- No Exchange Membership.

4/ Non-M ember General Brokerage Firms -- significant fund sales.

4a/ Same as Note 4 but sole proprietorship.

a. Periodic Increase in Salesmen's Commission

The correlation noted by the Wharton Report between expanding fund sales and higher sales charges is reflected at the retail level by the periodic use of increased sales commissions usually running for several weeks to several months. Typically a salesman who is allowed a commission of 50% (i.e. 50% of the dealer's concession which on most funds is a maximum of 6% of the offering price) will be raised to 60 to 75% on sales of a select group of funds, or the same result will be reached by paying the regular commission rate on an assumed 8% dealer concession.

(1) The NYSE Member Firms

E.F. Hutton has a firm policy against any incentives directed at selling mutual funds as opposed to other securities, even though increased sales were believed to be a natural consequence of such practice. The firm states that it does not want its representatives swayed from the objective of recommending suitable securities for its customers.

Mr. Ward said, however, that when a wholesaler of a fund whose management and performance are respected, announces a raised dealer concession, such information is passed on to the salesmen, who share in the increase by virtue of their regular 40% commission on fund sales.

Mr. Taylor at Dean Witter, expressed his firm's policy against special inducements for fund sales on the basis of his firms' primary business objectives:

"... we do not want to stress any particular end of our business. We are primarily underwriters and members of the New York Stock Exchange. A great many of us feel that every dollar you put into a fund takes away from your sales over the New York Stock Exchange."[161]

He also felt that contests and prizes resulted in many customers holding unsuitable investments.

At Mitchum, Jones & Templeton, for a two or three month period, the firm will increase the commissions payable on about five different fund groups, usually involving twenty to twenty-five funds. These funds are a part of the firm's "preferred" list of funds and

"...would be funds that by and large over a period of time we have had a nice relationship with [and from] which we get a greater amount of reciprocal commission than usual."[162]

Rather than periodically altering the firms' commission schedule, the desired incentive to sell the "preferred" funds is achieved by circulating a list of those funds from which as "assumed" 8% maximum dealer concession is paid, rather than the usual 6%. The salesman's normal 50% commission paid on those funds' shares nets him an effective rate of about 67% of the actual dealer commission.[163] The firm's objective is to enable its salesmen to share in the reciprocity received from the "preferred" funds.

Although this technique has been employed for several years, the firm is revising the compensation arrangement because of NYSE objection. It was believed that the NYSE's objection was founded on its unwritten policy of limiting salesmen's direct commissions to about 50% and that any extra incentives must be directly attributable to the recipient's individual sales performance.

The NYSE first objected to the techniques just described as a contravention of its policy in April 1963.[164]

In response, Mitchum, Jones & Templeton proposed a more or less permanent list of "Group A" funds on which the maximum dealer concessions (for salesmen's commission computation) would be equivalent to 7-1/2% for minimum orders, and scaled down as order size increased.[165] The firm said that the increased percentage represented "a proportion of our reciprocal commission [in addition[to the regular dealer concession."[166]

The NYSE still found the compensation arrangements contrary to its policy because it treated "... funds on an individual compensation basis which varies from fund to fund."[167] The NYSE suggested:

"On the other hand, if you wish to give production credit to your registered representatives for reciprocal business received by your firm as a result of their individual or collective efforts and you do set a specific and uniform percentage rate of compensation for that production credit, and that uniform percentage approximates any one of the percentage figures listed in your letter, the Exchange will have no objection."

Recognizing that the NYSE was saying in effect, that the same result could be achieved but that a tie-in to attributable reciprocity must be made, Mitchum, Jones & Templeton again wrote the NYSE proposing a simplified program whereby it would:

"... add a reciprocal bonus of 1% with respect to sales at any volume level, limiting such bonuses to just those funds previously outlined."[168]

Again the firm was told that the alternative suggested "... would not be consistent with Exchange philosophy and requirements."[169]

The NYSE "philosophy" apparently limits salesmen's compensation on fund shares to a maximum of about 50% but would allow for additional compensation based on the reciprocal business given the firm which in some way may be attributable to the salesman's “individual or collective efforts.”[170]

The problem of implementing such a standard were believed to involve: (i) the fact that all the firm's fund orders are executed through a central order department and the funds don't know which branch office or salesmen initiated the order; (ii) a salesman or branch office may have a big month in one fund in November while reciprocity is not received from that fund until March; (iii) the cumbersome bookkeeping involved in working back to each salesman, a credit representing his proportion of fund share sales as it related to total reciprocity received from the fund (or fund group). Plus the fact that the timing problem discussed in (ii) would still dampen sales motivation. Mr. Mainland said:

“... our present thinking is that -we are trying to work out some arrangement whereby the reciprocal is designated and computed by the funds and our sales by funds are set down by the percentage from each plan and by certain production credits at the end of a month or quarter relative to the sales or relative to the reciprocal and sales by each.”[171]

These problems were discussed and resolved in a series of telephone calls[172] between the firm and the Exchange and resulted in a plan under which the firm will credit an additional 1-1/2% of dollar volume to the actual dollar volume of sales made each month in the shares of seven fund groups.[173] The salesmen receive their regular 32% NYSE commission on this additional dollar volume credit. The firm has never received a clear policy statement from the Exchange as to its precise policy on maximum direct sales commissions or effective commission rates based on production or bonus payouts or credits.

(2) Regional Exchange Members

Pacific Northwest only once in the past three years has attempted to spur fund sales by means of directly increasing the salesmen's commission on particular funds. Instead it has in force a system of sliding-scale bonus payments depending on the salesmen's cumulative fund share sales volume in the 31 funds on its selected list,[174] during the 12 months preceding the sale. These bonus payments, as in the case of Mitchum, Jones & Templeton's program, are called reciprocal credits and are only in part, dependent on the firm's reciprocal income.

All income reciprocity and dealer concession received from the 15 management companies whose funds constitute the selected list are treated as a common pool from which bonus payments are made in accordance with a schedule[175] circulated to the salesmen. In essence the schedule, provides an increasingly higher reciprocal credit to each succeeding sale as the total sales of the proceeding twelve months increase from a low of $20,000 to $1,420,000, upon which the maximum credit is given.

Mr. Daniel stated that because the bonus credit system involved complicated bookkeeping procedures an attempt would be made to revise the mutual fund commission schedule to some fixed scale of percentages.

First California Company utilizes the previously described technique of treating the dealer concession from certain funds as though it were higher than what is actually received. At the end of August 1963 such an incentive program was in effect with respect to Fundamental Investors and Commonwealth Investment Co.[176] Mr. Egan, the company's President, pointed out that the expected reciprocity should cover the firms added costs but that the expected reciprocity should cover the firms added costs but that he could not be certain. About one year ago when a similar program on Fundamental Investors was in effect, the firm estimated an excess cost of $30,000 above their normal commission payout, without compensating reciprocity.

"The difference between what we got back and what we had to put out was not good, but we would rather have them [the salesmen] concentrate... We eventually went to whittle this [list of funds sold] down to, say, ten funds and this is our means of doing it."[177]

Although Table 3 indicates First California's holding of management company stock it is not passed on to individual salesmen. It resulted from the acquisition of Zilka, Smither, an Oregon broker-dealer, which prior to its acquisition, had participated in Capital Life's "franchised dealer" program for the acquisition of stock in its management company, Investors Counsel. First California has not acquired stock in any other management companies.

(3) Non-Member Firms

Mutual Fund Associates relies upon contests and prizes to a greater extent than any of the other firms interviewed but unlike the NYSE and regional exchange members does not pass on to its salesmen any increase in dealer concessions instituted by a fund wholesaler.

During the past year the following incentive programs were in operation.

(1) A year-long, firm-wide contest based on dollar volume of sales of all funds including "qualified" funds.[178] The three highest scoring salesmen and their wives will be given an expense paid trip to Boston, New York and Washington, D.C., during the course of which, they will meet some of the qualified funds' management personnel, and as guests of Kalb, Voorhis, visit the NASD Headquarters.

(2) A year-long, firm-wide manager's contest based on volume of fund sales with the same awards as the salesmen's contest described above.

(3) A one-month, firm-wide contest which will award a gold-plated pen in recognition of special effort.

(4) A contemplated region-wide contest, based on dollar volume, for the top ten percent of associates in each region.

(5) Periodic division (i.e., office) manager awards of small prizes are given to their salesmen for new accounts opened within a month. They will also hold small office-wide contests based on a salesmen's percentage of increase in dollar volume or number of sales in a month.

The costs of such contests and prizes for the seven months ended July 31, 1963 were estimated at about $5,230. Mr. Ferguson said that when business is poor, less money is spent on contests. He did emphasize, however, that contests do work and that they generally stimulate the salesmen to make more customer calls rather than increase the pressure of their sales approach.

California Investors, in addition to month-long sales contests in which expense-paid trips are awarded, also periodically increases the percentage of dealer concession on which salesmen's commissions are paid. In the latter part of 1962 this incentive was given for sales of the United and Keystone Funds because "... we felt we would get more reciprocal if we did."[179]

At Southwick, Campbell & Waterman a bonus arrangement based on total fund dollar volume enables its salesmen to increase their effective rate of fund commissions by about 5 to 10% on an annual basis.

The three principles of the firm acquired in Investors Counsel pursuant to Capital Life's franchised dealer program. Mr. Waterman said that the chance of acquiring management stock first attracted them to the fund but said that he felt the fund was a good investment on its own merits and that he and the other officers of the firm had bought a substantial number of shares for their own accounts.

As a sole proprietorship Mary Lou Brown has from time to time used one or two salesmen, but no formal incentive plans have been used. Miss Brown's decision as to her favored funds determine the sales direction of this dealer.

V. Views on Certain Industry Practices

At almost all the firms visited we invited an expression of opinion as to the effects of the elimination of price fixing in the distribution of fund shares; the need to revise the present advertising restrictions; and the adequacy of the generally prevailing 8-1/2% load and 6% dealer concession.

The results were generally and uniformly against the elimination of price fixing; in favor liberalizing the advertising rules; and of the opinion that the present load was not too high some thought a higher load was justified.

A. Repeal of the Fixed-Price Requirements

We asked what would happen to the retail firms if all retailers were free to charge any price they wished so long as the fund received net asset value for its shares. All reactions were generally negative.

1. Effects on Retailers and Funds

Mr. Ward at E.F. Hutton believed that a reasonable mark-up over net asset value would be between 3 and 6%,[180] depending on the size of the purchase.

Mr. Taylor at Dean, Witter, believed that there would be mass cancellations of sales agreements, and that there would be a reversion to a pre-1940 type trading market. He said that such a situation would be:

"... certainly not desirable. Then it would be dog eat dog. It is the same thing as saying if we didn't have the New York Stock [Exchange] Commission fix that I would do it for less than Merrill, Lynch. I certainly do no think that would help our business any... I think their [the funds] business would just drop practically to nothing, because you have to get new money in and the shares have to come from the fund. No one is going to work for less than the New York Stock Exchange Commission and, personally, I think it would slow the funds down so there would not be any particular amount of new sales if you had an open market."[181]

Mr. Southwick believed that:

"... certain companies would merge in making markets. There would be certain markets where you would determine there would be a market on Wellington Fund and a market here and there -No one outfit could handle all the funds. It runs into billions in size. Well, to me I can't see but what it would be a little chaotic."[182]

At California Investors Mr. Ross believed that the bigger firms would want to drive the small ones from the business. And Mary Lou Brown observed that

"... one of the greatest things is price fixing... Because nobody can under-price you and nobody does. The big houses can't run you out of the business.

2. Effects on Investors

At Mutual Fund Associates we pointed out that absent price fixing a fund investor could shop for the best available price and, no doubt, do better than an 8-1/2% load. We were told:

“That might be like going to a bank and dickering for your interest. The bigger borrower could drive a harder deal. I think when you are dealing with a large sum of money and a fiduciary relationship, it is a different area than buying a car or groceries. If you had a lot of cut throat competition, the professionalism would soon leave. Otherwise it would be very difficult to build a long term business. I think the public would suffer more than you gain.”[183]

With respect to “shopping around” Mr. Campbell believed that:

“... there would be a certain number of people who would listen to the sales presentation of one person and then shop around and try and buy it cheaper from someone else...”

He said however, that absent price-fixing, probably less attention would be drawn to the load because it would not be stated in the prospectus and consequently less price awareness would result. He said that

“... in the final analysis [I don't know] how much difference it would make. I think there would be a lot of confusion.”[184]

B. <u>Adequacy of the Present Load Structure</u>

Mr. Ward at E.F. Hutton said that on a sale of at least $2,000 the present average load is too high but on sales of $500 or on accumulation plans of $50 or $100 per month the loads were so low that his firm lost money. He believed that the larger purchasers were, in effect, subsidizing the smaller investors. He said:

“... I don't think the rich should carry the poor. I think that each transaction should stand on its own feet and should have a reasonable profit.

Now, the funds recognize that to a certain extent. By virtue of a letter of intent to purchase a substantial amount charge is reduced. I think what you need is a general modification of these charges, but I think you must be very careful and not get the charge for handling small transactions down to where we all lose money...”

At Dean Witter it was observed that the comparison between the 8-1/2% load and the 5% mark-up of over-the-counter shares was not so appropriate comparison. The dealer retains an effective rate of between 5% and 6%, not the full load. From an investors standpoint the cost of acquiring and subsequently selling a fund should be properly compared to the “in-and-out” cost of an odd lot.

"... you take [for example] a $10.00 stock on the New York Stock Exchange and if there happens to be a quarter point spread and it is an odd lot you are paying eight percent to buy that stock and most of your funds are in that particular price level."[185]

The Special Study made a similar observation:

"The combined effect of the [NYSE] commission and [odd-lot] differential may also be seen in the Exchange's Monthly Investment Plan, designed to permit small investors to purchase shares on a regular basis. An investor investing $60 a month pays a charge, commission and differential of 7.35 percent of the value of the security purchased in accumulating a $10 stock; or 6.35 percent for a $50 stock. This combined cost of commission and differential is less than the normal mutual fund loading charge, but the former covers only the purchase of shares and is duplicated on a sale, while the mutual fund load covers both purchase and redemption."[186]

At Mutual Fund Associates, we were told that a large fund retailer, in order to maintain proper supervision over its salesmen requires salaried managers and that the present dealer concession is insufficient to cover such expenses. This was one reason given by Mutual Fund Associates for seeking their present arrangement with Putnam Management Company.[187]

C. Advertising Rules and the Prospectus

All the firms which expressed an opinion on the present mutual fund advertising restrictions agreed that some liberalization would aid their sales efforts. Specific proposals for liberalization were not given but the objectives to be attained were described. Mr. Ward at E.F. Hutton would like to be able to treat a fund as any other investment recommendation and be able to distribute market letters similar in context to those describing other equity securities.

At Mitchum, Jones & Templeton we were told that the present restrictions were so confining as to render ineffective the use of any newspaper, radio and television commercials. It was noted however, that Dreyfus Fund was an exception. "Maybe they have found something the rest of the industry hasn't They are the only one that are accomplishing anything."[188]

At some firms we received additional comments on the role of the prospectus in relation to fund advertising. It was suggested that the prospectus requirement comes into play too soon in the normal setting of a fund sale.

"Lots of times you do not know what fund you would like to interest him in -at that point [when] you get down to the specific fund, that would be plenty soon enough to deliver a prospectus."[189]

From an investor's standpoint, we were told that:

"...It would be excellent to have a four or five page summary that would touch on the important points... I think this would help the investing public if they had less information but they read what they had and it was the most important part."[190]

And Mr. Ward at E.F. Hutton observed that "... the average member of the public has considerable difficulty in understanding the prospectus. It is a useless instrument as far as the average layman is concerned."[191]

At all the firms we visited we received words of commendation for the Commission's attempt to solicit industry views prior to the adoption of any proposed rules or statutory amendments. Most of the firm's executives expressed a willingness to come to Washington for informal talks with members of the Commission or its staff.

VI. Concluding Remarks

Although the precise reasons and market conditions that motivated the Commission and mutual fund industry to include the fixed-price provisions of Section 22(d) in the '40 Act are not articulated in its legislative history, twenty-four years of industry experience with the resulting market structure have lent the stamp of legitimacy to its operation in the American securities markets. Many dealers regard the price-fixed feature of fund selling as in large measure responsible for the dynamic growth of the industry in the past twenty-four years. Although some criticisms of Section 22(d) has been heard in recent years, the fact remains that a vast broker-dealer network has grown and taken root under the resulting market structure and it would seem that it would be necessary to demonstrate some clear and present dangers in the present system before it can be discarded.

Implicit in our discussion of the mutual fund retail market structure has been the possibility of amending the '40 Act to create a market model which would allow competition among dealers to the extent of their dealer concession. That is, fund shares could be sold by retail dealers at a negotiated price between a statutorily set maximum sales load and a minimum of net asset value plus the principal underwriter's spread.

The fixed price structure does not seem to have contributed significantly to the problems raised recently in the Special Study of Securities Markets in the areas of fund sales. The problem of improving sales presentations, salesmen's training and supervision does not seem to be connected in any meaningful way with the price fixed feature of the prevailing market structure.

Fixed retail prices generally tend to benefit smaller dealers and elimination of this system could possibly drive such dealers out of business or make necessary the institution of even greater high pressure sales techniques to make up for the loss of income per sale. The effects of instituting free pricing at the dealer level may also have adverse consequences in that resultant price cutting would lead dealers to pressure the funds for increasing reciprocal brokerage benefits and give impetus to a search by the funds for new and more subtle ways to channel rewards to dealers who sell their shares. In any event, this study does indicate that current dealer concessions (absent reciprocal income) are presently inadequate in some smaller and medium size firms to sustain the costs of fund retailing operations. Whether the industry and the public would be benefited by a program which might cut such dealers from the market is a policy question which this study will not attempt to answer.

It is possible that the objective of lowering the investor's cost of fund ownership, in fact, might not be attained in the “free market” envisioned. It is difficult to predict the results which this market model may bring about. For example, the effect on the present fund share “gray” market is not clear. It is possible that if dealers reduced their prices to attract customers the economic squeeze on many non-member firms would prompt them to cancel their existing fund sales agreements with the hope of making greater profits by trading fund shares in the gray market like Smith, Burris and Asiel & Co. It is more likely, however, that the presently operating gray market firms would abandon their operations altogether if their aggregate spread became unprofitable because of the availability of shares at about the same price from many other contract-dealers.

At the level of the potential fund investor, his relative bargaining power would probably determine his ultimate fund share purchase price. For example, if Bank X presently wishes to buy Wellington Fund for its customer, it has to pay the underwriter, the full retail price. Bank X may buy Wellington in the gray market from Smith, Burris at or slightly below net asset value plus the underwriter's commission. Under the hypothetical “free” market model, Bache & Co., which perhaps might be looking for stock exchange commission business from the bank -or for some other reason -could sell Wellington shares to Bank X at the same price as is presently available from Smith, Burris. Further, under the hypothetical model Bache & Co. could charge Bank X the minimum price allowed by statute, while at the same time it might charge the average individual investor the maximum allowable sales price, and still another individual some in-between amount. These differences in bargaining power between Bank X and the individuals might lead to consistently higher prices being paid by the average fund investor as opposed to institutions and certain broker-dealers, thus affording the benefits of price reductions to only a small part of the public.[192]

In addition, there is no assurance that potential investors will develop the necessary price consciousness to shop around or bargain for a sales change below the maximum allowable sales price. Witness the relatively slow growth of sales of no-load funds or, to choose an example from a not too dissimilar field, savings bank life insurance.[193]

As we have noted it is entirely possible that what investors as a group may have gained in lower sales costs might be lost through higher fund expenses incurred as a result of greater pressures exerted on the funds to generate reciprocity as compensation for the reduced revenues that might be received by the dealers on their fund sales.

Lastly, the impact of an altered market model on the broker-dealer community is unclear. The number of firms of salesmen that would be forced to leave the business cannot be predicted, but our interviews indicate that the numbers might be significant.

* * * * *

There appears to be no serious attempt within the brokerage community to institute cost accounting techniques with respect to types of securities sold nor any systematic attempts by the firms to locate the merchandise yielding the greatest profitability. The principals of the firms we interviewed had heard of no industry efforts along these lines, except for the NYSE's Special Cost Study, which was generally felt to be somewhat inaccurate and not instructive as to proper cost allocations.

The actual sales dollars spent by the multi-line firms on their diverse merchandise could not be identified. In several firms we were told that there was disagreement among the partners as to which areas of business was most profitable. At Dean, Witter as well as Southwick, Campbell & Waterman, our questions prompted a heated discussion of this problem by the firms' principals.

One thing appears clear, however. The NYSE members, as a group, receive more reciprocal income per dollar of fund shares sold than non-NYSE members. They also are able to retain a greater percent of their dealer concession than the non-members because of their ability to employ salesmen who receive, as a group, lower fund commissions than the salesmen employed by the non-NYSE member firms. As previously indicated, this potential advantage or “head start” may not be fully reflected in the profit columns of their income statements because of the high overhead costs that are incurred by the multi-line NYSE firms.

* * * * *

The use of selected lists of one form or another is very common among firms doing a substantial fund business. The criteria of selection within any one firm are determined by the need to offer funds which will meet the varying objectives of investors, the past personal relationships with fund managements, the pre-conditioning of the market by a fund through advertising or general reputation and the desire for reciprocal reward. The dominance of any one factor within a firm, or with respect to a particular fund, was very difficult to identify, but the desire for reciprocity echos through the dealer community as the leitmotif upon which the theme of selection is built.

We have seen how reciprocal rewards flow from the funds to the retail dealers and in turn to the salesmen. In the case of the NYSE members the “excess” brokerage commissions are easily funneled to other exchange members. However, in attempting to pass on reciprocal income to their salesmen, the NYSE members face the obstacles of Exchange policy met by Mitchum, Jones & Templeton. The non-NYSE members encounter no outside interference in rewarding their salesmen out of reciprocal income. Their problem is obtaining it in the first instance. The firms which have no exchange affiliation feel particularly deprived because of the NYSE's commission splitting rules, and (except in rare instances) their inability to take advantage of regional exchange execution patterns that have developed.

ENDNOTES

[1] Report of Special Study Securities Markets of the Securities and Exchange Commission, H.R. Doc No. 95, 88th Cong., 1st Sess. (1963), Part 4, Chap. XI, p. 95. [hereinafter cited as "Special Study"]. Among these dealers are the large selling organizations composed mostly of part-time salesmen such as the Hamilton Management Corp., Waddell & Reed and King, Merritt & Co. See id. at 102-104.

[2] It has been observed that the recent expansion of the broker-dealer community has been not only in the number of firms but more significantly in terms of increasing size of existing firms. Bache & Co., for example, since 1945 increased its capital from $4 million to $31 million, its number of salesmen from 100 to 1,414 and its gross income from $8 million in 1947 to $58 million in its fiscal year ending January 1962. The number of registered representatives employed by all New York Stock Exchange (NYSE) firms increased more than four times in the 1945-1962 period, while branch offices of member firms increased from 841 to 2,737 in the same period. Special Study, Part 1, Chap. I, p. 22.

[3] As of February 28, 1962

[4] Based on a sample of NYSE member firms, the estimated gross income from mutual funds average 4-1/2% of total gross income. Special Study, Part 1, Chap. I, p. 34.

[5] This estimate was made by Harold Oberg, Research Director of the Investment Company Institute, in a telephone conversation with Lawrence Newman of the staff on January 30, 1964. It was also partially verified by certain statistical projections based on responses collected by Special Study.

[6] Some fund shares could only be acquired directly from the company or its investment counsel.

[7] The problems connected with the frequency of the computation of the net assets of the portfolio and time period in which the offering or redemption price derived therefrom were in effect, is discussed infra.

[8] The term is used in SEC, Investment Trusts and Investment Companies, Part Three, Ch. III, 865 (1940) [hereafter cited as "Study"].

[9] NASD Memorandum 4, February 5, 1958, SEC File No. S 7-170-1, Proposal To Adopt Rule 22(d)(I).

[10] Study, Part Three, Ch. III, p. 856; Part Two, Ch. III, p. 242.

[11] I.e. the net asset value (bid) and public offering price (asked).

[12] Study, Part Two, p. 325.

[13] Study, Part Three, Ch. III, p. 858 ff.

[14] Even Less frequent pricing methods obtained before this procedure gained common acceptance. Study, Part Three, Ch. III, p. 860.

[15] Dealers could often borrow stock for delivery to customers.

[16] In practical operation the two-price system and its diluting effects were further complicated by the possibility of several alternative instructions to, and actions by, the executing dealer. The following dialogue occurred between Senator Robert F. Wagner, Chairman of the Senate subcommittee, and Baldwin B. Bane, Director of the Commission's Registration Division: Hearings on S. 3580 before a subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess., 839 (1940).

SENATOR WAGNER: As I understand, I put in my order to the dealer.

MR. BANE: That is right.

SENATOR WAGNER: At the higher price, I suppose, is it?

MR. BANE: No. You put your order in, and --

SENATOR WAGNER:(Interposing). Just to buy?

MR. BANE: No. If the price is determined, for instance, on yesterday's close, whatever that price was you buy so many shares at that price today. You give that order to the dealer, and we will say your order is for 100 shares at $5.60.

SENATOR WAGNER: And let us say that the next day it is fixed at $4.

MR. BANE: All right.

SENATOR WAGNER: What do you pay?

MR. BANE: You pay $5.60 unless, as some underwriters have worked it out with the dealer, you put your order in to buy 100 shares N.A. That "N.A." means just prior to the next advance. Or to hold them S.L. if the market is looking down. Or you can send in orders, as Massachusetts Distributors does, and have the order marked to be executed at the lower of two prices after the new price is determined. Then they will execute it at the lower price.

SENATOR WAGNER: One other question right there.

MR. BANE: Am I making myself clearer to you?

SENATOR WAGNER: Yes; let me go back to the $5.60. Let us say that I make no condition at all. I want 20 shares of some particular trust, and it is during the day that I put in my order, let us say at $5. How, at that time you say the dealer knows the price, it having been fixed for the next day, and he knows that it will be $4. Without saying anything else what does he pay?

MR. BANE: He will --

SENATOR WAGNER:(Continuing). Does he pay $5 or $4? Does he give us the advantage of the lower price?

MR. BANE: Many dealers do, but some do not.

SENATOR WAGNER: Does that mean that somebody else may make that difference?

MR. BANE: There is the difficult thing under this two-price system. A dealer may very well protect his customer and give his customer the benefit of the lower price, the $4 price, let him buy at the lower price, hold back his order. And let us say that he does that for the benefit of that particular customer. He gets him in the trust, and he does it for the next customer, and when he does it for the benefit of the customer he is now selling he is diluting the interest of the man already in. In other words, he is working in favor of his customer then coming in but to the disadvantage of the one he has already sold to last month. The higher price in declining markets is not received to offset in some degree this lower price received in rising markets.

SENATOR WAGNER: Then it is not so simple, is it?

MR. BANE: No, sir; I do not think it is. [Laughter]

[17] No registered investment company shall sell any redeemable security issued by it to any person except either to or through a principal underwriter for distribution or at a

current public offering price described in the prospectus, and, if such class of security is being currently offered to the public by or through an underwriter, no principal underwriter of such security and no dealer shall sell any such security to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus: Provided, however That nothing in this subsection shall prevent a sale made (i) pursuant to an offer of exchange permitted by section 11 hereof including any offer made pursuant to clause (1) or (2) of section 11(b); (ii) pursuant to an offer made solely to all registered holders of the securities, or of a particular class or series of securities issued by the company proportionate to their holdings or proportionate to any cash distribution made to them by the company (subject to appropriate qualifications designed solely to avoid issuance of fractional securities); or (iii) in accordance with rules and regulations of the Commission made pursuant to subsection (b) of section 12."

[18] Hearings on S. 3580 before a subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess., 16 (1940).

[19] Id. at 1052.

[20] Id. at 1057.

[21] Hearings on H.R. 10065 before a subcommittee of the House Committee on Interstate and Foreign Commerce, 76th Cong., 3d Sess., 99 (1940).

[22] See, for example, the letters from Harold F. Goodbody to Ganson Purcell, dated August 8, 1940, and from Richards & Blum, Inc., to David Schenker, dated August 6, 1940. Such letters were possibly suggested by a form letter, dated August 1, 1940, circulated to dealers by Lowell Niebuhr & Co. Inc. It stated, in part, that "[Sec. 22(d)] protects only the underwriters, and is antagonistic to the interests of the investor and dealer. Our representatives are in Washington now in an attempt to have this paragraph eliminated. We strongly urge you to cooperate by sending wires at once to David Schenker of the Securities & Exchange Commission, Washington, D.C. and to your senators and representatives urging elimination of this paragraph." SEC Files No. 124-10.

[23] The Commission minutes of August 6, 1940 disclose that Messrs. L. A. Motley, W. T. Gardiner, M. E. Traylor, N. Vance, J. Hinke and Jaretzki were present. "The discussion related particularly to a suggested amendment to Section 22(d), urged by independent dealers in investment trust securities, which would remove the present restriction against the sale -at other than a current public offering price described in the prospectus (except sales to other dealers).

"At the conclusion of the discussion, the Commission advised the representative of the industry present that, particularly in view of its announced endorsement of the Bill in its entirety, it would not at the present time advocate any change in the said Section 22(d)."

According to a letter dated August 13, 1940 to Commissioner Robert E. Healy from Asiel & Co., Mr. Gabriel Litt, a member of that firm was also present.

[24] NASD Memorandum 4, supra, p. 4, note 2. The "undesirable practices" involved the previously discussed cut-price competition which was hampering the contractual distribution system of fund shares. Other reasons for the adoption of Section 22(d) were said to be that the fund underwriters and contract dealers whose efforts and expenses developed the national fund market were unable to compete with the non contract dealers and that a system of competitive pricing discouraged sound selling practices.

[25] Prior to the approval by the NASD's Board of Governors and membership and the SEC filing, a final draft of Section 26 was submitted to the staff and the Commission for informal consideration. The Commission did not commit itself as favoring the Rule and reserved the right to hold public hearings on its merits. See letters from Wallace H. Fulton, Executive Director, NASD, to John Hollands, Assistant Director, Investment Company Director, SEC, dated January 11, 1941, and Jerome N. Frank, Chairman, SEC, to Wallace H. Fulton, dated January 15, 1941, SEC File No. 132-3.

Even earlier drafts were submitted for the Commission's information and staff members suggested certain provision. See, Proposed Addition to Article II of the Rules of Fair Practice of the NASD with comments for submission to the SEC as requested by Judge Healy 18 (Draft of December 20, 1940). SEC File No. 16-1-3 (Non-Public).

[26] See, Memorandum to John Hollands from Ludwig H. Gerber re Proposed amendment to the Rules of Fair Practice of the National Association of Securities Dealers, Inc., dated April 8, 1941, SEC File No. 16-1-3 (Non-Public).

[27] In a letter to Chairmen Frank dated March 13, 1941 from Joseph Gannon of May & Gannon, broker-dealers in unlisted securities, it was stated "--that if these rules are given the official approval of the Securities and Exchange Commission, it will be another instance similar to the incorporation of section 22D in the Investment Company Act of 1940, when the private interests of the investment trust underwriters triumphed over the common interests of the investing public and the security dealers." SEC File, No. 124-10.

[28] Of the 2,934 members eligible to vote 1,825 cast ballots; 1,347 in favor and 478 against the new rules. Memorandum, note 1, p. 16, supra.

[29] See, Transcript of Public Conference, March 28, 1941, SEC File No. 4-31-1. In his testimony before the Commission Joseph Gannon of May & Gannon charged that Section 26 was drafted by an NASD subcommittee which was entirely composed of representatives of fund distributors; that the proposed rules were unfairly presented to the membership and without the objections that were raised by some firms; and that many members didn't vote because of fear of economic reprisal.

[30] 9 SEC 38 (April 12, 1941), allowed Section 26 to become effective June 1, 1941.

[31] Id. at 43.

[32] Id. at 44. This time lag was said to take at least a week. Letter of March 20, 1941 to the Commission from F. L. Putnam & Company, Inc. And it was said that the only reason for paragraph (j)(2) was to attempt to cut down or eliminate the trading market in fund shares. Letter of March 26, 1941 to the Commission from Goodbody & Co., SEC File No. 4-31-1.

[33] 9 SEC 38, 44 (April 12, 1941)

[34] Id. at 45.

[35] Id. at 46, n. 12.

[36] Section 26(e)(1) was revised as of September 29, 1952 to reflect a change in trading hours of the New York Stock Exchange.

[37] See: NASD, Explanation of Draft Revision of Investment Company Securities Rule, dated January 14, 1963 ("Draft"); Comments on Draft Submitted January 14, 1963 of NASD Rules of Fair Practice Dealing with Investment Company Securities, dated January 17, 1963; Memorandum of Conference Re: Draft 1/14/63, dated February 25, 1963; Letter of March 9, 1963 from Covington & Burling to Allan F. Conwill; Draft of 2/18/63 and 3/8/63; Staff Comments on Revised Pages Bearing Designations "Draft 2/18/63" and "Draft 3/8/63," Inserted in Draft Revision of NASD Rule of Fair Practice Dealing with Investment Company Securities dated March 20, 1963; Draft of 3/22/63; Letter of March 25, 1963 from Covington & Burling to Allan F. Conwill.

[38] Subparagraph (p) Draft of 10/23/62. This paragraph was maintained through the Draft of 1/14/63 but was dropped from the Draft of 2/18/63 and subsequent Drafts. See, Letter of March 9, 1963 from Covington & Burlington to Allan F. Conwill, p. 2. The writer of that letter, David Isbell, in a telephone conversation on July 8, 1963 with Mr. Lehr of the staff expressed the opinion that subparagraph (p) was dropped at the suggestion of the NASD's Board of Governors because its provisions are invariably incorporated in selling agreements and would therefore be superfluous.

[39] This opinion was expressed by Mr. Moulden in a telephone conversation with Mr. Lehr of the staff on July 8, 1963, and again at an interview at his office on July 11, 1963.

[40] Inv. Co. Act, Rel 87, March 14, 1941.

[41] NASD Manual J-70 (1962).

[42] Information with respect to fund share trading at Asiel & Co. is based upon an interview at the firm conducted by Mr. Eisenberg of the staff and an examination of the firm by the NASD. See Memorandum of Conference at Asiel & Co., 20 Broad Street, N.Y.C., Tuesday, March 12, 1963 and NASD, Report of Special Examination, Re: Analysis of Market and Trading Practices of Open-End Involvement Company Shares, dated August 3, 1962, ("NASD, Report"). Information about Smith, Burris & Co. is based upon an interview at its office, 120 S. LaSalle Street, Chicago, Illinois, on July 2, 1963, conducted by Messrs. Mundheim and Lehr of the staff. See Memorandum of Conference: Smith, Burris.

[43] Exhibit 1 is a copy of the list furnished by Mr. Erzberger covering the volume of shares bought, sold, and redeemed – during the first six months of 1963, and the years 1962 and 1961 of the following funds:

1. M.I.T. 2. M.I. Growth 3. Wellington 4. Affiliated 5. Dreyfus 6. Keystone S-4 7. Life Insurance Investors 8. Putnam Growth 9. Boston Fund 10. Chemical 11. Dividend Shares 12. Lazard 13. State Street 14. Fidelity Capital

[44] Neither Section 22(d) of the '40 Act nor the applicable NASD rules prohibit a sale from one dealer to another at below the public offering price.

[45] In a purchase from the fund the principal underwriter's spread would be \$.40 on this transaction, and the selling dealer would retain \$.97.

[46] See, Table 1, p. 35, infra.

[47] In the case of Lazard and State Street, shares may be sold at less than net asset value because of the fixed price provisions of Section 22(d) do not apply since shares are not currently being offered by these funds.

[48] NASD, Report 4.

[49] See Exhibit 2.

[50] Information with respect to fund shares trading at MLPFS is based upon interviews at the firm's New York offices at 54 Wall Street, conducted by Messrs. Eisenberg and Lehr of the staff on July 15, 1963, and at a Washington, D.C. branch office, 815 15th Street, N.W., conducted by Mr. Lehr on July 25, 1963. See Memorandum of Conference: Merrill, Lynch and Memorandum of Conference: Merrill Lynch – Branch Office.

[51] As noted at p. 21, supra., both the '40 Act and the NASD rules would permit a "cross" of a fund buy and sell order below the public offering price where MLPFS acts as broker for one or both parties.

[52] See letter to Meyer Eisenberg from MLPFS dated August 8, 1963.

[53] In certain circumstances the premium may be more than off-set by the firm's transaction charge to the customer, which it imposes on some agency transactions in fund shares.

[54] Mr. Warren said he knew of no other dealers making fund share markets.

[55] Mr. Warren noted that all customer fund share orders are handled by one of MLPFS fifty-four traders, and that such orders represented only about 50% of his time.

[56] See n.1 p. 29, supra.

[57] See NASD Rules of Fair Practice, Section 26(c)

[58] On January 21, 1964, the Wall Street Journal carried the following Investment Company Institute's summary of mutual fund sales and redemption figures: (000 omitted):

	Sales	Redemptions	Net Increase
1963	$2,459,105	$1,505,335	$ 953,770
1962	2,699,049	1,122,695	1,576,354
1961	2,950,860	1,160,357	1,790,503
1960	2,097,246	841,815	1,255,431
1959	2,279,982	785,627	1,494,355
1958	1,619,768	511,263	1,108,505
1957	1,390,557	405,716	984,841
1956	1,346,738	432,750	913,988

[59] The firm does not compile dollar volume figures for the securities it sells. It reconstructed these figures from the individual order "tickets" for the period.

[60] The June 1963 dollar volume figure of $216,608.20 was multiplied by 12. Mr. Warren believed that June, 1963 was a representative month upon which to estimate the yearly totals presented herein.

[61] See the example given by Mr. Erzberger, supra. at p. 25

[62] Appendix A is a copy of a memorandum illustrating the variations in dealer concession and underwriter's spread for a representative group of funds from pre'40 Act to the present. The dealers' costs salesmen's commissions, overhead, etc. that are paid out of the dealer concession are discussed in Chapter Two.

[63] Appendix B is a copy of a memorandum illustrating the difficulty in comparing the flotation costs of mutual fund shares with other securities.

[64] Special Study, Part 4, Chap. XI, pp. 102-107.

[65] The role of the wholesale representative is discussed infra

[66] The Broad Street Group, The T. Rowe Price Organization, The Axe-Houghton Mutual Fund Complex, the IDS Complex, The Vance Sanders Mutual Fund Complex.

[67] Previously, several large NYSE-members were interviewed for the sole purpose of getting information about the role of selected lists in the industry. The 9 firms interviewed on the Pacific coast confirm the national prevalence of such lists. See pp. 70-77, infra.

[68] "Gross commissions" as used herein include retail agency commissions, retail principal spreads, mutual fund commissions and underwriting commissions on spreads. It does not include income derived from the firm's trading account or interest and dividend income.

[69] On the basis of the financial information supplied for the first six months of 1963, listed business, OTC and fund business represented respectively 46%, 36% and 6% of the firm's gross commission business.

[70] Testimony of Richard T. Jones at Mitchum, Jones & Templeton, p. 110 (August 30, 1963).

[71] See the discussion of this venture under "California Investors," infra.

[72] On basis of financial information supplied for the first half of 1963, OTC, mutual fund and listed business represented respectively, 53%, 19% and 10% on a gross commission basis.

[73] Mr. Daniel explained the origin of the advisory formula as a concept "...that management ought to be around on the same side of the table as the shareholder, and we felt that we couldn't get a fund off the ground and get it to going unless our incentive was right there and not something that was based on net asset value... So it was necessary, we felt, to set an advisory fee which in good times would work higher to our benefit and make up for the periods when things went dry. This, again, led to a feeling that we had to compensate for... the possibility that there might be extended periods of high management fee by setting a lower load..." Testimony of Robert E. Daniel at Pacific Northwest Company, P. 8 (August 22, 1963)

[74] Testimony of Mary Lou Brown, p. 43 (August 29, 1963).

[75] Id. at 48.

[76] Ibid.

[77] New York Stock Exchange, Security Commission Business Calendar Year 1962. The limitations on the accuracy and usefulness of this publication, which is based on the NYSE's Special Cost Study are described in the Special Study Part 2, Chap. VII., pp. 334 ff.

[78] Testimony of Eaton Taylor at Dean Witter & Co. p. 6 (Aug. 26, 1963)

[79] Testimony of Glen H. Southwick at Southwick, Campbell & Waterman p. 68 (Aug. 23, 1963).

[80] Testimony of Eaton Taylor at Dean Witter & Co. p. 9 (Aug. 26, 1963).

[81] Testimony of Colin A. Campbell at Southwick, Campbell & Waterman pp. 70, 71 (Aug. 23, 1960).

[82] The Special Study, Part 2, Chap VI I (1) discusses the types of reciprocal arrangements that obtain between NYSE members and non-members.

[83] Because Pacific Northwest salesmen receive 15% on all listed stocks regardless of where the order is executed they have no financial interest in the choice of market.

[84] Testimony of Ed Pocock at Pacific Northwest Company p. 13 (August 22, 1963).

[85] Testimony of Joslyn H. Waterman at Southwick, Campbell & Waterman pp. 72, 73 (August 23, 1963).

[86] See pp. 104, 105 infra. This was confirmed in a telephone conversation on September 26, 1963 between Dennis Lehr of the staff and Irvin J. Whitehill, General Partner of Dean Witter & Co.

[87] See pp. 65, 65 infra.

[88] Testimony of Eaton Taylor at Dean Witter & Co. p. 34 (August 26, 1963).

[89] Testimony of Murray Ward at E.F. Hutton & Company pp. 16,17 (August 29, 1963)

[90] Id. at 24, 25.

[91] Testimony of Allen G. Mainland at Mitchum, Jones & Templeton p. 80 (August 30, 1963).

[92] Testimony of Messrs. Richard T. Jones and Carl G. Gebhart at Mitchum, Jones & Templeton pp. 99-104 (August 30, 1963).

[93] The specific weaknesses, apart from the limited sampling, that contribute to the inconclusiveness of some of the following interpretations and correlations will be appropriately noted.

[94] Reciprocal income of all types less give-ups paid, reduced by 40% in the case of portfolio brokerage to estimate the cost of carrying out the executions and services performed.

[95] Similar data on listed and OTC sales could not be derived because sales volume figures were provided by only 3 of the 9 firms.

[96] It was found that the furnishing of investment research and statistical services ranked second in the reasons given by adviser groups for the allocation of portfolio brokerage. A Study of Mutual Funds, H. Rep. No. 2274, 87th Cong., 2d Sess., p. 527 (1962) [hereinafter cited as "Wharton Report"].

[97] The actual rate of profit that may be derived from this cost advantage depends, however, upon the properly allocable expense items to fund operations. The overhead costs of the member firms may conceivably offset this advantage.

[98] The fact that 32% of its business is in municipal bonds may account for this disparity. See p. 48 supra. No other firm interviewed did a significant percentage of municipal bond business.

[99] Mary Lou Brown was not considered since there were no deductions of partners or managers salaries thus rendering the profit margin incomparable. However, if about $6,000 were taken out by Miss Brown during the first half of 1963, the firm would show no profit.

[100] The percent of gross income derived from mutual fund sales for all NYSE members in the Special Study's sample was 4.5%. See, Special Study, Part I, Chap. I, p. 34.

[101] The exception of Southwick, Campbell & Waterman also suggests that profit margins may be proportionately higher in those firms doing a substantial municipal bond business.

[102] Special Study, Part 4, Chap. XI, pp. 2, 13-33.

[103] Id. at 213.

[104] Wharton Report 527. It was also noted that the sale of fund shares was a factor influencing brokerage allocation in 63 of the 83 open-end groups surveyed. See Table VIII-70.

[105] Id. at 534-35. See discussion of reciprocal ratios at pp. 535-37 of the Wharton Report.

[106] Prospectus, Fundamental Investors, Inc., quoted in the Special Study, Part 4, Chap. XI, p. 215.

[107] Agreement between Fundamental Investors, Inc. and Hugh W. Long & Co. These agreements will also generally contain a provision that such firms and the services rendered by them be satisfactory and that the cost of such services would not exceed "normal charges".

[108] The Wharton Report, as noted previously, made clear that the major "service" for which brokerage was given was the sale of fund shares. Special Study Chap. XI. C. at pp. 216, 217. Also, Wharton Report, at 527.

[109] See Special Study Part 2, Chap. VIII, C. 4. c. discussing reciprocal practices of institutional investors.

[110] Special Study, Part 4, Chap. XI, C., pp. 217-218.

[111] Id. at 218.

[112] Testimony of Eugen J. Habas, at the public hearings of the Special Study of Securities Markets, May, 1962, p. 335-36.

[113] See, Special Study, Chapters II; III, B; and XI.

[114] These firms were:

E.F. Hutton & Co. Lee Higgenson Corp. Kidder, Peabody & Co. F. I. DuPont Eastman Dillon, Union Securities & Co. Reynolds & Co. Shields & Co. Ferris & Co.

All except Ferris & Co., a District of Columbia firm, were interviewed in their main offices in New York City.

[115] See the discussion of inducements to retailers and their salesmen at pp. 107-11. infra.

[116] The types of reciprocity patterns encountered have been described at pp. 95-97, infra.

[117] The role of the wholesaler is discussed at pp. 98,99, infra.

[118] See pp. 102-104, infra.

[119] Reciprocity and sales volume were comparable among the nine firms only for the 6-month period ending June 30, 1963. Because of a time lag between dealer sales and reciprocal reward, the reciprocity reported by the dealers may not be considered direct compensation for sales made during that period. It would have been desirable to have reciprocal income figures for the year ending June 30, 1964, in order to test the percentage of reciprocal business received by the dealers in relation to fund sales for the first half of 1963.

[120] DuPont estimates that a fund will generally have available three times as much brokerage as the amount of new shares sold. Memorandum of conference at F.I. DuPont, & Co., March 13, 1963, p. 1. Reynolds & Co. compares ratios from previous years and present ratios from other similar funds. Memorandum of conference at Reynolds & Co., March 12, 1963, p. 6.

[121] See testimony of George M. Ferris at Ferris & Co., pp. 35-50, (March 8, 1963), describing the manner in which Ferris keeps records of fund sales and reciprocal business and prods fund managements when he feels that satisfactory levels have not been maintained. Mr. Ferris reviews his records quarterly and writes letters to funds after each review (p. 37). The standards of reciprocity expected "is based on total reciprocity to total sales of funds. I realize that different funds may have different degrees of activity for many different reasons, so it is a vague guide rule for me." (p. 38) The reciprocity level was higher than 1:1 during 1961-1962, according to Mr. Ferris, "between one and two to one." (p. 47). During 1962 Ferris & Co. sold the following amounts of fund shares (in each of its top 10 management groups) and received the following brokerage commissions:

Fund	1962 $ Amount Shares Sold	Net Brokerage Commission Rec'd	Reciprocity ratio %
Vance Sanders	$396,464	$3800	.96
North American Securities	358,667	5600	1.52
Crosby Corp.	317,756	5682	1.78
Putnam Fund	232,790	2933	1.26
Hugh W. Long	219,626	6300	2.86
Natl. Securities & Research	196,171	4751	2.42
Lord Abbett	181,593	1566	.86
Keystone Co. of Boston	167,808	2088	1.24
Parker Corp.	141,837	2521	1.78
Securities Co. of Mass.	107,380	642	.60
Totals	$2,320,092	$ 35,883	

Thus Ferris & Co.'s reciprocal ratios averaged 1.55% and exceeded 1% in all but 3 cases of the 10.

Mr. Ferris stated:

"...once we have the sales record of what we have done with the fund, then I approach it and try to get as much reciprocity as I can from the fund, which for good investment reasons we have concentrated upon.

* * *

But, I get as much reciprocity as I can on those sales, because I feel that this is a basic relationship of any form of business. It is true in relationships with banks. It is true in relationships with any form of business." (Id. at 40.)

"We try to decide which are the best funds for various objectives for the individual. In effect, we try to judge their investment management ability and the amount we have sold of those funds, and we try to get reciprocity business.

“They have to give it somewhere. It is a good source of income...

“I quarterly talk with the banks in which we have accounts and judge total reciprocity in relation to total accounts. I do the exact same thing as I do in this area. This is one approach." (Id. at 44)

Pacific Northwest Company indicated its general reciprocal "target was about 1-1/2%." (Testimony of Robert E. Daniel at Pacific Northwest Company, p. 29, Aug. 22, 1963.) Mr. Eagen of First California Company stated that where the firm raises the salesman's percentage on certain funds (i.e. a campaign is made) it could normally expect "1 to 1-1/2, maybe 2 percent" in reciprocal business. (Testimony of Jack Eagan at First California Company, pp. 30-31, Aug. 28, 1963)

Many firms concede that some firms consistently give a small reciprocal (MIT and Putnam were mentioned most often), and do not respond to calls or letters requesting higher reciprocal rates -yet because of their popularity none have been dropped or de-emphasized.

[122] In 1962, e.g., E.F. Hutton & Co. and Lee Higginson. Hutton indicated that it received from its top 10 selling fund groups reciprocal on fund sales alone $167,764 in brokerage business (a 1.77% ratio on sales of $9,450,383) plus another $47,560 for research and other services; a total of $215,324 in brokerage from these top 10 groups, a ratio of 2.28%. About 90% of Hutton's sales were in these top ten groups.

Lee Higginson, with total fund sales of $2,647,165 during 1962 received $143,004 in brokerage commissions from all funds (including funds which are not sold by the firm, e.g. $67,325 from IDS for research and other services) of which $30,648 was credited to mutual fund sales efforts, a ratio of 1.16%. During 1961 fund sales totaled $3,560,135, fund brokerage amounted to $79,158 of which $37,651 was credited to the mutual fund department for sales efforts, a ratio of 1.06%. Some firms such as Mitchum, Jones & Templeton were not able to break down the bases for their reciprocal income.

123 Testimony of Ed Pocock at Pacific Northwest Company, pp. 27-28, (Aug. 22, 1963) See Exhibit No. 4 for a copy of this firm's selected list.

124 Testimony of Jack Eagan at First California, pp. 24, 31-34 (Aug. 28, 1963); testimony of Neil T. Ferguson at Mutual Fund Associates, p. 48 (Aug. 27, 1963); testimony of Stanley L. Ross at California Investors, pp. 136-137 (Aug. 30, 1963).

125 The four, however, included Reynolds & Co. and Eastman Dillon, representing a substantial volume of fund sales. Several firms however, refused such participation on the policy ground that this incentive created conflicts or was otherwise inappropriate. See memorandum of conference at Kidder, Peabody & Co., Mar. 13, 1963, p. 5; Memorandum of Conference at Shields & Co., Mar. 12, 1963, p. 4; Testimony of Murray Ward at E.F. Hutton & Co., pp. 27-28 (Aug. 29, 1963).

126 Some of the difficulties encountered in such arrangements are discussed in connection with Mitchum, Jones & Templeton's commission scale, p. 109, infra.

127 Interview with Donald Phillips, Paul Fagin and Edward Holshuh at E.F. Hutton, March 13, 1963.

128 Testimony of Julia Montgomery, partner, Ferris & Co., p. 10 (Mar. 8, 1963).

129 Id. at 7.

130 Questions may be raised whether the use of a selected list made up on the basis of highest reciprocal, without revealing the ground for such selection, is fraudulent under Sections 10(b) and 15(c) of the 1934 Act.

131 The service performed for the retail dealers by the funds' wholesale representatives are included in this category.

132 The factors determining allocation of reciprocity by the funds are described in Chapter XI, C. 2. of the Special Study.

133 See pp. 102, 104, infra.

[134] It was generally agreed although the firms kept no statistics that if mutual funds represented, e.g. 20% of a firm's gross profit on security sales, the firm's salesmen had to spend more than 20% of their total selling time on fund business.

[135] See pp. 62, 63 supra.

[136] These benefits may be provided in the form of sales material from Wiesenberger or Kalb, Voorhis. This type of reciprocity was not identified as income on the dealers' financial statements.

[137] See p. 59 supra.

[138] Testimony of Robert E. Daniel at Pacific Northwest Company, p. 28, (August 22, 1963).

[139] Infrequently the firm may receive reciprocity when a fund is able to cross a block through a member of the Detroit Stock Exchange because of that Exchange's rules allowing 50% of the regular commission rate to be paid to NASD members. The PCE and Cincinnati Stock Exchange also permit commission splitting with NASD members, but at Mutual Fund Associates, this was not a significant source of reciprocity.

[140] See for example A Report on the Vance, Sanders Mutual Fund Complex, p. 164 (1963). See also Exhibit No. 5, for the dealer record of Pacific Northwest on Putnam Fund Distributors and Mitchum, Jones & Templeton on Vance, Sanders Co.

[141] We were advised that "... the industry has been very wary of this subject and there has been no discussion of specific amounts. They have been avoiding discussions of specific amounts in this area of reciprocal business." Testimony of Richard Jones at Mitchum, Jones & Templeton, p. 108 (August 30, 1963)

[142] The customary ratios are described in Chapter XI, C of the Special Study, and p. 72, supra

[143] Testimony of Robert E. Daniel at Pacific Northwest Company, p. 29. (August 22, 1963).

[144] The relationship between the retailer's selected list and its restrictions on the wholesaler's access to its salesmen has been mentioned at p. 77. supra

[145] Testimony of Murray Ward at E.F. Hutton & Company, p. 27. (August 29, 1963).

[146] See pp. 77,88 supra.

[147] Testimony of Richard Jones at Mitchum, Jones & Templeton, p. 115 (August 30, 1963).

[148] Mary Lou Brown, being a sole proprietorship and doing about 50% of her business in Fidelity Funds, is not visited by as many wholesale representatives as the other firms.

[149] Testimony of Neil T. Ferguson at Mutual Fund Associates, p. 53 (August 27, 1963).

[150] As defined in Part 2 of the Special Study, p. 295.

[151] The rates payable on transactions in other securities are taken directly from the schedules submitted by the dealers. The salesmen's stated rate of compensation on mutual funds in every firm was higher than on listed business and OTC businesses.

[152] See, "Special Incentives," infra.

[153] E.F. Hutton & Co. discussed at p. 104 infra.

[154] Testimony of Stanley L. Ross at California Investors, p. 130. (August 30, 1963).

[155] Id. at 131.

[156] Mary Lou Brown was not comparable because no salesmen were employed.

[157] The uses of production or bonus credits is discussed infra.

[158] Although the salesman receives no direct financial reward on exchange business, the firm obtains valuable sales assistance through its arrangement with Sutro & Company. See 96, 97. supra.

[159] Excluding Mutual Fund Associates which does almost no listed business.

[160] In this connection, some firms, for limited periods of time, will increase their salesmen's commissions on certain funds even though on the actual sale of those funds' shares, no profit may be realized. Their expectation of increased reciprocal income which may not materialize motivates such a program. See the discussion concerning First California Company at p. 112, infra.

[161] Testimony of Eaton Taylor at Dean, Witter & Co., p. 25 (August 26, 1963). Mr. Taylor personally would like to see his firm increase its fund sales efforts because of his belief in its relatively higher profitability. See p. 62 supra.

[162] Testimony of Allen G. Mainland at Mitchum, Jones & Templeton, p. 84 (August 30, 1963).

163 The firm also has a branch manager's incentive plan based on overall profitability of his office. Consequently the manager's compensation is not directly dependent on sales volumes of any one class of securities.

164 In March 1963, Arthur Platow, Manager, Department of Member Firms, New York Stock Exchange, inquired as to the existence of any special incentive program in the firm. Information about a recently completed program of the kind just described involving three fund groups was furnished. See letter dated April 22, 1963 to Arthur Platow, from Carl G. Gebhart, and, letter dated April 29, 1963 to Carl G. Gebhart from Arthur Platow, reproduced as Exhibit 6.

165 See Exhibit 7.

166 Exhibit 7, p. 1.

167 Letter dated June 25, 1963, to Carl G. Gebhart from Walter Coleman, Assistant Director, Department of Member Firms, New York Stock Exchange.

168 Letter dated June 28, 1963 to Walter Coleman from Mitchum, Jones & Templeton.

169 Letter dated July 10, 1963 to Carl G. Gebhart from Walter Coleman.

170 See note 4 p. 108, supra.

171 Testimony of Allen G. Mainland at Mitchum, Jones & Templeton, p. 84 (August 30, 1963).

172 Letter dated October 25, 1963 to Meyer Eisenberg from Mitchum, Jones & Templeton.

173 The total amount of such additional volume credit will not exceed the total of all reciprocal commissions from all sources during the month. The original list of fund groups for October 1963 is: National Securities, Group Securities, Hugh Long, United Funds, American Funds, Keystone Funds and One William Street Fund. Of this group, National Securities, Hugh Long and Keystone were among the firm's top five fund groups in the six months ending June 30, 1963.

174 Exhibit 4.

175 Exhibit 8.

176 These funds are on the firm's selected list.

177 Testimony of John F. Egan at First California Company p. 31 (August 28, 1963).

178 Qualified funds are those on which a higher number of contest points are earned and higher commissions are payable. They represent the firms selected list. See Exhibit 9 for complete "Top Leaders Award" contest rules.

179 Testimony of Stanley Ross at California Investors p. 136 (August 30, 1963).

180 See p. 117 as to his opinion on the adequacy of the present load structure.

181 Testimony of Eaton Taylor at Dean, Witter & Company p. 31 (August 26, 1963).

182 Testimony of Glen H. Southwick at Southwick, Campbell & Waterman p. 116 (August 23, 1963).

183 Testimony of Neil T. Ferguson at Mutual Fund Associates, p. 82 (August 27, 1963).

184 Testimony of Colin A. Campbell at Southwick, Campbell & Waterman p. 118 (August 23, 1963).

185 Testimony of Eaton Taylor at Dean, Witter & Company p. 29 (August 26, 1963).

186 Special Study Part 2 Chap. VI, p. 326.

187 See p. 51 supra for a description of the Putnam arrangement.

188 Testimony of Carl G. Gebhart at Mitchum, Jones & Templeton, p. 112 (August 30, 1963).

189 Testimony of Neil T. Ferguson at Mutual Fund Associates p. 86 (August 27, 1963).

190 Id. at 87.

191 Testimony of Murray Ward at E.F. Hutton & Company p. 24 (August 29, 1963).

192 Some provision could, of course, be made which would force a dealer, once he has set his price, to deal on the same terms with all customers. We cannot here anticipate all of the positive models which might be employed, but the effect of any change in the present pricing structure must obviously be evaluated carefully because of secondary or more remote effects might well be significant and unpredictable.

193 On the other hand, the growth of direct writing auto insurance companies indicate the presence of a contrary trend in some areas.

EXHIBIT 1

Smith, Burris & Co.: Fund Transactions

		Liquidated		Purchases		Sales	
		Shares	$ Volume	Shares	$ Volume	Shares	$ Volume
Boston Fund	1961	6,832	133,540.43	3,553	67,833.24	3,169	3,457.69
	1962	8,754	98,311.36	6,609	64,622.15	2,055	32,892.71
	1963*	3,039	29,289.92	2,768	26,661.22	---	
Mass. Inv. Trust	1961	25,005	375,596.97	18,658	309,911.42	7,500	84,233.97
	1962	25,790	361,992.23	22,829	317,991.08	3,100	45,929.80
	1963	8,531	119,270.93	5,967	83,941.04	2,987	41,674.89
Lazard Fund	1961	4,662	77,735.33	2,560	43,395.89	2,148	34,943.45
	1962	4,511	63,121.75	2,353	34,393.74	1,468	19,025.50
	1963	796	11,893.91	53	812.64	1,492	21,794.15
Life Ins. Inv.	1961	11,644	190,470.28	14,513	244,882.28		
	1962	17,277	304,231.81	16,321	280,893.94		
	1963	6,745	115,216.24	4,508	78,962.48		
State Street Inv.	1961	10,458	436,748.67	6,734	288,634.51	4,424	174,684.78
	1962	13,997	519,617.63	4,331	174,731.00	9,750	347,341.01
	1963	4,745	179,222.65	1,896	71,330.25	2,665	100,917.40
Affiliated Fd.	1961	41,166	340,313.37	30,533	253,869.50	8,500	70,142.97
	1962	36,680	279,207.36	25,646	199,146.95	10,400	76,053.47
	1963	13,430	107,330.15	11,756	82,924.53	3,330	26,755.54
Chemical Fund	1961	13,209	162,448.31	7,813	96,270.31	5,664	68,624.10
	1962	10,423	112,438.55	7,165	81,948.05	2,150	20,081.19
	1963	8,727	93,633.52	725	7,543.65	8,589	91,886.77
Dividend, Shs Inc.	1961	17,888	61,420.32	12,745	42,869.15	6,300	21,869.24
	1962	52,283	163,111.56	21,272	68,043.51	33,679	103,589.18
	1963	22,321	75,154.45	4,197	13,860.43	14,900	50,783.42

Dreyfus Fund 1961 5,351 91,532.71 5,007 86,262.75 479 7,280.00
1962 9,752 152,968.00 9,536 149,624.96 1963 6,190 102,310.92 3,450
55,398.46 1,096 18,779.50 Fidelity Capital Fd. 1961 23,727 485,970.92 22,845
468,589.75 1962 13,400 127,860.46 10,195 113,658.42 3,251
24,308.25 1963 3,533 29,496.46 1,844 15,208.33 2,424 19,892.99

Keystone Custodian 1961 47,915 305,195.22 54,579 345,156.67 -Custodian (S-4) 1962
43,157 200,868.18 37,619 165,779.28 1963 7,072 29,826.64 6,022
25,286.35 ---

Mass. Inv. Growth 1961 28,427 523,776.56 28,126 519,446.41 -Stk. Co 1962
68,375 640,162.32 66,187 624,335.72 1,500 10,500.00 1963 11,259
91,114.40 9,297 74,616.06 2,500 20,509.04

Putnam Growth 1961 44,371 726,516.62 46,432 745,048.33 -Stk, Fd. 1962 42,621
397,065.06 38,272 356,848.14 2,000 13,729.60 1963 5,442 46,263.04
3,904 33,092.51 Wellington Fd. 1961 37,515 573,060.06 35,814 550,390.79
1962 47,743 694,585.38 38,870 568,532.00 5,236 70,873.60 1963 10,180
147,246.41 9,053 129,836.84 ---

* First six months only, for all funds

EXHIBIT 2

[Illegible Handwritten Chart]

EXHIBIT 3

EQUITY FUND, INC. ANNUAL ADVISORY FEE AS A % OF YEAR-END NET ASSETS

FEE	ADVISORY FEE AS % OF NET ASSETS	NET ASSETS (YEAR-END)	ADVISORY
1962	$ 20,967,525	$ 225,154	1.1%
1961	21,762,665	240,907	1.1
1960	16,237,528	189,430	1.2
1959	16,612,564	198,585	1.2
1958	14,654,889	190,162	1.3
1957	10,717,152	141,517	1.3
1956	11,934,447	167,334	1.4
1955	11,359,949	161,014	1.4
1954	9,614,746	177,130	1.8
1953	7,076,945	87,612	1.2
1952	7,207,668	103,407	1.4
1951	6,280,951	119,879	1.9
1950	5,497,213	69,030	1.3
1949	4,235,282	46,781	1.1
1948	3,455,762	40,966	1.2
1947	3,756,280	38,524	1.0
1946	3,770,332	40,625	1.1
1945	3,948,573	83,673	2.1
1944	3,190,668	37,136	1.2
1943	2,170,501	27,732	1.3
1942	1,695,645	0	0
1941	1,519,334	0	0
1940	2,059,328	0	0
1939	2,172,495	10,230	0.5
1938	2,197,922	13,491	0.6
1937	1,258,634	31,885	2.5
1936	1,648,709	13,358	0.8
1935	796,059	15,843	2.0
1934	477,619	1,442	0.3
1933	300,513	3,945	1.3
1932	62,198	0	0

EXHIBIT 4

[Illegible chart]

CURRENT MUTUAL FUND PREFERENCE LIST for Reciprocal Business

Affiliated Fund American Business Shares

Boston Fund Massachusetts Investors Trust Massachusetts Investors Growth Stock Fund Canada General Fund

Broad Street Investing Corp. National Investors Corp. Whitehall Fund

Century Shares Trust

Chemical Fund

Colonial Fund Colonial Growth & Energy Shares

Delaware Fund

Diversified Growth Stock Fund Fundamental Investors Diversified Investment Fund

Eaton & Howard Stock Fund Eaton & Howard Balanced Fund

Equity Fund, Inc.

Fidelity Fund Fidelity Capital Fund Fidelity Trend Fund Puritan Fund

Group Securities

Incorporated Income Fund Incorporated Investors

Putnam Fund Putnam Growth Fund

Wellington Fund Wellington Equity Fund

EXHIBIT 5

Letter from

MITCHUM, JONES & TEMPLETON 510 South Spring Street Los Angeles 90013

Allen G. Mainland Vice President and Treasurer

Los Angeles, Calif. October 17, 1963

[Received stamp dated Oct 21, 1963, U.S. Securities and Exchange Commission]

Mr. Meyer Eisenberg Securities and Exchange Commission Washington 25, D.C.

Dear Mr. Eisenberg:

Supplementing the material forwarded to you a few days ago, there is enclosed copy of a work sheet which is typical of the records we keep of directed commissions received from brokers on instructions from mutual fund organizations. This one covers commissions received on instructions from Vance, Sanders & Co., the sponsor of Massachusetts Investors Trust.

This material is sent pursuant to your request at the time of your visit to our office in late August, 1963.

Very truly yours,

MITCHUM, JONES & TEMPLETON Incorporated By Allen G. Mainland

[Attachment illegible]

EXHIBIT 6

TO ALL OFFICES

SUBJECT: MUTUAL FUND INCENTIVE PROGRAM

A special sales credit of 8% on orders under the first breakpoint will be in effect beginning Tuesday, January 8, 1963, and continuing through March 29, 1963, on a select group of mutual funds which includes the following:

(1)National Securities, (2) Hugh W. Long, and (3) Waddell & Reed. A total of 15 different mutual funds embracing a wide variety of investment objectives Is managed by the above three groups.

The mutual funds included in the List and the sales credits at different levels are as follows:

I. National Securities & Research Corp.

Bond Series Balanced Series Preferred Stock Series Income Series Stock Series Dividend Series Growth Stock Series

Size	Acquisition Charge	Our Sales Credit Under
$25,000	8.5%	8%
25,000 to 49,999	5.5%	5.5%
50,000 to 99,999	5%	5.5%

II. Hugh V. Long & Company, Inc.

Diversified Growth Stock Fund, Inc. Diversified Investment Fund, Inc. Fundamental Investors, Inc.

Size	Acquisition Charge	Our Sales Credit Under
$10,000	8.75%	8%
10,000 to 24,999	7.5%	7.5%
25,000 to 49,999	5.75%	5.5%
50,000 to 99,999	4%	4%

III. Waddell & Reed, Inc.

United Accumulative Fund United Continental Fund United Income Fund United International Fund United Science Fund

Under $25,000 the acquisition cost is 8-1/2% on all the above funds except United International Fund, which is 8.8%. Our sales credit will be 8% on all five of the W & R funds under $25, 000.

CARL G. GEBHART

CGG/dl January 8, 1963

****

Los Angeles 14, California April 22, 1963

Mr. Arthur Platow Department of Member Firms New York Stock Exchange Eleven Wall Street New York 5, New York

Dear Mr. Platow

In answer to your telephone call of last April 18, 1963, please be advised that from January 8, 1963, through March 29, 1963, Mitchum, Jones & Templeton, Inc., added an additional sales credit on mutual fund orders in three funds groups, which included: (1) National Securities & Research Corp. (Bond Series, Balanced Series, Preferred Stock Series, Income Series, Stock Series, Dividend Series, and Growth Stock Series), (2) Hugh W. Long & Company, Inc. (Diversified Growth Stock Fund, Inc., Diversified Investment Fund, Inc., and Fundamental Investors, Inc.) and (3) Waddell & Reed, Inc. (United Accumulative, Continental, Income, International, and Science Funds).

The extra credit was calculated as follows:

NATIONAL SECURITIES, 6% dealer concession plus 2% on single orders under $25,000; 4% dealer concession plus 1.5% on single orders from $25,000 to $49,999.

HUGH W. LONG, 7% dealer concession plus 1% on single orders under $10, 000; 6% dealer concession plus 2% on orders from 10,000 to $24,999; 4.60% dealer concession plus 0.90% on single orders from $25,000 to $49,999.

WADDELL & REED, INC. 6% dealer concession plus 2% on single orders under $24,999.

Our regular commission rate of 50% on mutual fund sales of course applied during this period. No trips, prizes, or other awards were involved; the added sales credits were the only factors in this incentive program.

Please let me know if we can be of further assistance.

Very truly yours,.

Carl G. Gebhart Vice President and Secretary

CGG/dl

cc A.G. Mainland R.W. Jones

****

NEW YORK STOCK EXCHANGE ELEVEN WALL STREET NEW YORK 5, N.Y.

DEPARTMENT OF MEMBER FIRMS DIVISION OF MEMBER OFFICES AND PERSONNEL

April 29, 1963

Mr. Carl G. Gebhart Vice President & Secretary Mitchum, Jones & Templeton, Inc. 650 South Spring Street Los Angeles 14, California

Dear Mr. Gebhart:

Thank you for your letter of April 22, with details of the additional sales credit you allowed to your registered employees during the period from January 8, 1963 through March 29, 1963, on mutual fund orders in three funds groups.

Such additional sales credit is not consistent with Exchange policy, and should not be repeated without specific prior approval of the Exchange.

Since it is our understanding that you were unaware of the Exchange's position in the matter heretofore, the Exchange has determined to take no action in respect of the additional sales credit you did allow during the period in question.

Very truly yours,

Arthur Platow Manager

EXHIBIT 7

Los Angeles 14, California June 21, 1963

Mr. Walter Coleman Department of Member Firms New York Stock Exchange Eleven Wall Street New York 5, New York

Dear Mr. Coleman:

Subject to New York Stock Exchange approval, we propose to add a proportion of our reciprocal commission to the regular dealer concession with respect to a list of mutual fund management groups on a semi-permanent basis. We would propose to classify the above mentioned funds as so-called Group "A" funds. Sales credit on all other mutual funds not included on the Group "A" list would remain at dealer concession.

The specific details of our proposal would be as follows:

GROUP "A" MANAGEMENTS AND FUNDS

Hugh W. Long & Co. (Diversified Growth Stock Fund, Diversified Investment Fund, and Fundamental Investors)

Single Orders under $10,000: 7% plus 1/2% or 7-1/2%

Single Orders 10,000 15,000: 6% plus 1-1/2% or 7-1/2%

Single Orders 15,000 25,000: 6% plus 1% or 7%

Single Orders 25,000 – 50,000: 4.60% plus 0. 90% or 5-1/2%

Single Orders 50,000 99, 999: 3.20% plus 0. 80% or 4%

American Funds (American Mutual Fund, Investment Company of America, International Resources Fund, Washington Mutual Fund)

Single Orders $0 – 5,000: 6-3/4% plus 3/4% or 7-1/2%

Single Orders 5,000 15,000: 6-1/2% plus 1% or 7-1/2

Single Orders 15,000 – 25,000: 5-3/4% plus 1-1/2% or 7%

Single Orders 25,000 50,000: 5% plus 1/2% or 5-1/2%

Single Orders 50,000 – 99,000: 3-1/2% plus 1/2% or 4%

One William Street (The One William Street Fund, Inc.)

Single Orders under $10,000: 7% plus 1/2% or 7-1/2%

10,000 15,000: 6% plus 1-1/2% or 7-1/2%

15,000 25,000: 6% plus 1% or 7%

25,000 – 50,000: 5% plus 1/2% or 5-1/2%

50,000 99, 999: 3.60% plus 0. 4% or 4%

Waddell & Reed, Inc. (United Income Fund, United Accumulative Fund)

Single Orders $0 15,000: 6% plus 1-1/2% or 7-1/2%

Single Orders 15 25,000: 6% plus 1% or 7%

Adjusted on larger scales

Keystone Custodian Funds (All Series except B 1)

Single Orders $0 – 15,000: 6% plus 1-1/2% or 7-1/2%

Single Orders 15,000 25, 000: 6% plus 1% or 7%

Single Orders 25,000 50,000: 4% plus 1-1/2% or 5-1/2%

Single Orders 50,000 99, 999: 2.85% plus 1.15% or 4%

National Securities Series (Stock, Growth, Income, Dividend, Preferred Balanced, and Bond Series)

Single Orders $0 25,000: 6% plus 1-1/2% or 7-1/2%

Single Orders 25,000 50,000: 4% plus 1-1/2% or 5-1/2%

Single Orders 50,000 99,999: 3.75% plus 0.25% or 4%

We believe the foregoing list of management groups, representing more than 25 different mutual funds, provides objectives to meet virtually every need and similarly provides a well-diversified range of qualified managements. You will also note that certain constructive advantages are obtained through an .effective equalizing of sales credits throughout the list, eliminating obvious inconsistencies of the “trade.”

Pleas, advise us with respect to this matter at an early date as we would plan to institute the program in July, 1963, if possible.

Sincerely,

MITCHUM, JONES & TEMPLETON, Incorporated

Carl C. Gebhart Vice President and Secretary

CCC:b

EXHIBIT 8

PACIFIC NORTHWEST COMPANY

Inter-office Correspondence

To: All Salesmen
Date: January 2, 1962
From: Earl B. Dusenbery
Subject: Future Mutual Fund Program

The object of this memo is to describe the program which we expect will be a permanent one for Mutual Fund sales from here forward. During 1961 we had a very successful campaign to enlarge our Mutual Fund sales and I am sure everyone was pleased with the results. We are hopeful that the period ahead will be one in which all salesmen will continue to use Funds in their investment work in increasing amounts, and this of course is the objective of the overall program.

The last page of this memo carries a chart which shows a compensation schedule by way of Reciprocal Credit which will be paid to salesmen for the sale of Mutual Funds shown on the list. No change is being made in those Funds which qualify for the Reciprocal Credit at this time. The only alteration that has been made is to readjust the schedule to base it on a twelve month moving total of Fund sales rather than six months as it has been just recently. The objective here is to give men credit more in relation to their long-term Mutual Funds sales results and reduce the effect of either a particularly large or particularly small month's results. Because 1961 was a record year in Fund sales for the firm and undoubtedly for virtually every man in it, using 1961 as the base for the start of the new program in '62 should provide a real boost for all salesmen.

The method of computation for the new program is identical with that used in the last six months. With this in mind no detailed explanation will be made of it here, but additional copies of the memo of July 3 are available for those who wish to review the computation method. On the back of the table which we will use in computing the Fund Reciprocal Credit are several examples of the credit computation for your information. Examining these examples, it is easy to see that the extra credit occurring to you with consistently large Mutual Fund sales is going to be sizable indeed.

Where a $10,000 order in Mutual Funds occurs to a man who has had almost no Fund sales during a period of the last twelve months; and, therefore, is in the lowest bracket, as far as credit is concerned, the extra compensation amounts to only $30. A very large producer, on the other hand, who on an annual basis sells, for example, $800,000 in

Mutual Funds the credit for the same $10,000 sale would be $70. The maximum credit for an individual sale, in addition to the gross using the $10,000 example would be $100.

It is hoped that the continuation of this extra compensation will stimulate more large Fund sales. Again, an examination of the compensation chart reveals that a large order, over $250,000, in one unit may actually earn for the salesman more commission from the Fund Reciprocal Credit than from his portion of the gross in the deal.

The circumstances regarding new salesmen, who have either come to the firm in the last year or will join the firm after January 2, is the same as described in the memo of July 3.

Now that I am assuming responsibility for the activity that Bill Pratt previously carried forward, I hope you will feel free to contact me with any questions you may have and expect to get full assistance from me and the Seattle office in all of your Fund business.

EBD:mv

[Attachments illegible]

EXHIBIT 9

MUTUAL FUND ASSOCIATES, INCORPORATED
700 MONTGOMERY STREET, SAN FRANCISCO 11, CALIFORNIA

TOP LEADERS AWARDS

WHERE ARE YOU GOING IN 1964 ?????

How about a visit to Boston, New York and Washington, D. C. to see such things as The Putnam Management Company, Waddell & Reed's management office in New York, and the 1964 World's Fair, to name just a few?

Here is a great new opportunity for all Associates to enjoy an all expense paid trip to the East Coast on a truly outstanding itinerary. An opportunity to visit top mutual fund management companies . . . to hear words of wisdom from men at the top to personally see and talk with top management and top producers in the mutual fund and insurance fields . . . to enjoy tours of the nation's financial headquarters . . .the nation's capitol . . and many other wonderful places.

TOP LEADERS AWARDS

AWARD #1
An all-expense paid trip to the East Coast for the ASSOCIATE OF THE YEAR 1963 and his wife.

AWARDS #2 AND #3
The same all expense paid trip to the East Coast for TWO MORE MFA-IIA Associates and their wives.

As one of MFA-IIA's TOP LEADERS you will:

VISIT BOSTON

VISIT NEW YORK

VISIT WASHINGTON, D. C.

IN BOSTON
you will visit The Putnam Management Company to see first hand a mutual fund management company in operation and will talk with some of Putnam's Trustees and top management men informally.

As guests of George Putnam Jr., you will visit at his Manchester home and be treated to a typical Boston type “clambake.”

As guests of Ted Lyman, you will be entertained on his boat at Duxbury.

As guests of Dr. Vannevar Bush and Stanley Teele, and other top Putnam people, you will be hosted at a luncheon in your honor.

IN NEW YORK
you will visit the United Funds, Inc. management office and get a first hand look at their operations.

As guests of Chauncey Waddell, Director of United Funds and Waddell & Reed, you will be hosted at his penthouse across from the United Nations.

You will tour Wall Street.

You will enjoy sightseeing in New York and will have time to attend the 1964 World’s Fair in New York City.

IN WASHINGTON, D. C.
you will tour the nation’s capitol seeing such historic sights as the Washington Monument, Jefferson and Lincoln Memorials, the Smithsonian Institution, and the Houses of Congress, to name just a very few.

As guests of the Kalb-Voorhis Co. you will visit the National Association of Securities Dealers headquarters in the District of Columbia.

These will be experiences and memories that no amount of money can buy. There will be opportunities to do things you’ve always dreamed about, and see things you’ve only heard of or read about.

WHO IS ELIGIBLE?

All Associates of MFA-IIA are eligible for these outstanding awards. Every Associate has a real opportunity to succeed and qualify as one of the TOP LEADERS making this trip. Your personal production is your passport.

HOW TO EARN THE TRIP

The qualifying period is the calendar year 1963 -- January 1 thru December 31.

Each month, commencing with the month of January and continuing for 12 consecutive months, the TOP 25 ASSOCIATES will be ranked on a basis of points. Here is how you earn the RANKING POINTS.

1) 2 points for each dollar of adjusted qualified fund business.
2) 1 point for each dollar of adjusted non-qualified fund business.
3) 25 points for each dollar of commission income from IIA, and other MFA and IIA commission earnings.

This will determine the TOP 25 ASSOCIATES for the month. The TOP 25 will then receive AWARDS-RANKING POINTS.

AWARD RANKING POINTS

The TOP 25 ASSOCIATES for a given month will receive ranking points on the basis of their position in the top 25 as follows:

1)The NUMBER ONE Associate for the month -- 25 Points
2)The NUMBER TWO Associate for the month -- 24 Points
3)The NUMBER THREE Associate for the month -- 23 Points
-- and so forth, until –
25)The NUMBER TWENTY-FIVE Associate for the month -- 1 Point

The Two Associates (other than the Associate of the Year who automatically qualifies) who earn the most Awards-Ranking points cumulatively for the year on this monthly basis will earn this TOP LEADERS AWARDS trip to the East Coast.

<u>RECOGNITION</u>

The monthly rankings and the cumulative point rankings for the year to date will be published each month. THE COLUMN.

The TOP LEADERS (all 25) for the period designated, will receive handsomely inscribed plaques indicating that they are MFA’s TOP 25 ASSOCIATES for 1963.

<u>YOU HAVE A REAL CHANCE TO WIN!</u>

APPENDIX A

MEMORANDUM

April 9, 1964

To: Gordon D. Henderson

From: Dennis J. Lehr

Subject: Dealer Concession as Percent of Sales Load

The attached table, for the period 1939 through 1963, illustrates the proportionate increase in dealer concession paid in relation to total sales load.

The funds in the people were chosen from among the ten currently largest management groups,[1] excluding funds from the IDS and Waddell & Reed groups because sales in those groups are effected respectively by fully integrated and partially integrated sales forces.

The information was obtained from the semi-annual Mutual Fund Directory published by the investment Dealers' Digest, and figures are given only for the maximum possible sales load, distributors spread, and dealer-concession, as would obtain on sales up to the first break point.

It is interesting to note that in MIT and Century (since Vance, Sanders because distributor), although the dealer concession as a percent of the load has increased, the principal underwriter's spread has remained constant. No other fund exhibited this result. In the case of all funds the dealer concession as a percent of the load has increased. In eight cases out of ten the absolute size of the load has increased. In the case of American Business Shares there was a period of reduction followed by subsequent increase. Wellington has maintained a constant eight percent load.

[1] In the case of Keystone, figures are given for all 10 custodian funds.

<u>VARIATION IN DEALER CONCESSION AS PERCENT OF SALES LOAD: A SAMPLE</u>

Company and Year Organized	Year	Sales Load % of Purchase Price	Distributor's Share of Sales Load % of P.P	Dealer Concession as % of P.P.	Dealer Concession as % of Sales Load
Affiliated Fund – 1934					
	06-30-39	8.5%	3.0%	5.5%	64.7%
	12-31-39	"	"	"	"
	12-41-40	"	"	"	"
	06-30-41	"	"	"	"
	06-30-43	"	"	"	"
	12-31-46	"	2.5	6.0	70.7
	12-31-48	"	"	"	"
	12-31-51	7.5	1.5	"	80.0
	12-31-53	"	"	"	"
	12-31-55	"	"	"	"
	12-31-58	"	"	"	"
	12-31-60	"	"	"	"
	12-31-62	"	"	"	"
	06-30-63	"	"	"	"
American Business Shares - 1932					
	06-30-39	8.6%	3.1%	5.5%	64.0%
	12-31-39	"	"	"	"
	12-31-40	"	"	"	"
	06-30-41	"	"	"	"
	06-30-43	"	"	"	"
	12-31-46	"	2.6%	6.0%	69.7%
	12-31-48	"	"	"	"
	12-31-51	7.5	1.5	"	80.0
	12-31-53	6.25	1.25	5.0	"
	12-31-55	"	"	"	"
	12-31-58	"	"	"	"
	12-31-60	"	"	"	"
	12-31-62	7.5	1.5	6.0	"
	06-30-63	"	"	"	"
Broad Street Investing Corp - 1929					
	06-30-39	6.5%	2.3%	4.2%	64.7%
	12-31-39	"	"	"	"
	12-31-40	7.5	2.5-3*	4.5-5*	60.0-66.6*

06-30-41	"	2.0-2.5*	5.0-5.5*	66.6=73.3*
06-30-43	"	"	"	"
12-31-46	"	2.5%	5.0%	66.7%
12-31-48	"	"	"	"
12-31-51	"	"	"	"
12-31-53	"	1.5	6.0	80.0
12-31-55	"	"	"	"
12-31-58	"	"	"	"
12-31-60	"	"	"	"
12-31-62	"	"	"	"
06-30-63	"	"	"	"

* depending on volume

Bullock Fund Ltd. - 1932

06-30-39	6.75%	2.75%	4.0%	59.3%
12-31-39	"	"	"	"
12-31-40	"	3.66	5.0	57.7
06-30-41	"	"	"	"
06-30-43	"	"	"	"
12-31-46	"	2.66%	6.0	69.3
12-31-48	"	"	"	"
12-31-51	7.5	"	"	"
12-31-53	"	"	"	"
12-31-55	"	"	"	"
12-31-58	"	"	"	"
12-31-60	"	"	"	"
12-31-62	8.5	"	"	"
06-30-63	"	"	"	"

Century Shares Trust – 1928

06-30-39	7.0%	3.0%	4.0%	57.2%
12-31-39	"	"	"	"
12-31-40	"	"	"	"
06-30-41	"	"	"	"
06-30-43	"	"	"	"
12-31-46	"	"	"	"
12-31-48	"	"	"	"
12-31-51	7.5	2.5	5.0	66.7
12-31-53	"	"	"	"
12-31-55	"	"	"	"
12-31-58	"	"	"	"
12-31-60	"	"	"	"
12-31-62	8.5	"	6.0	70.7

06-30-63	"	"	"	"

Fidelity Fund, Inc. 1930

06-30-39	7.2%	2.7%	4.5% *	62.7%
12-31-39	"	"	"	"
12-31-40	"	3.4	6.25	86.8
06-30-41	"	"	"	"
06-30-43	"	"	"	"
12-31-46	"	1.2	6.0	83.5
12-31-48	7.5	1.5	"	80.0
12-31-51	"	"	"	"
12-31-53	"	"	"	"
12-31-55	"	"	"	"
12-31-58	"	"	"	"
12-31-60	"	"	"	"
12-31-62	"	"	"	"
06-30-63	"	"	"	"

* Plus and additional 1/4 or 1/2 if sales exceed 500 or 1,000 in a month.

Fundamental Investors, Inc, 1932

06-30-39	8.0%	2.7%	5.0%	62.5%
12-31-39	"	"	"	"
12-31-40	8.75	2.75	6.0	68.7
06-30-41	"	"	"	"
06-30-43	"	"	"	"
12-31-46	"	"	"	"
12-31-48	"	"	"	"
12-31-51	"	"	"	"
12-31-53	"	"	"	"
12-31-55	"	2.25	6.5	74.2
12-31-58	"	"	"	"
12-31-60	"	1.75	7.0	80.0
12-31-62	"	"	"	"
06-30-63	"	"	"	"

Keystone Custodian Funds - 1932
B - 1,2,3,4
K - 1,2
S - 1,2,3,4

06-30-39	7.75%	3.75%	4.0%	53.3%
12-31-39	"	"	"	"

12-31-40	8.3	3.3	5.0	60.2
06-30-41	"	"	"	"
06-30-43	"	"	"	"
12-31-46	"	"	5.0	"
12-31-48	"	"	"	"
12-31-51	"	"	"	"
12-31-53	8.3**	2.3**	6.0**	72.3
12-31-55	"	"	"	"
12-31-58	"	"	"	"
12-31-60	"	"	"	"
12-31-62	"	"	"	"
06-30-63	"	"	"	"

* Except on B-1 where no concession is given on the percent of U.S. Government bonds in the portfolio.
** About one half this rate for B-1.

MIT - 1924

06-30-39	7.0%	2.5%	4.5%	64.3%
12-31-39	"	"	"	"
12-31-40	"	"	"	"
06-30-41	"	"	"	"
06-30-43	"	"	"	"
12-31-46	"	"	"	"
12-31-48	7.5	"	5.0	66.7
12-31-51	"	"	"	"
12-31-53	"	"	"	"
12-31-55	"	"	"	"
12-31-58	"	"	"	"
12-31-60	"	"	"	"
12-31-62	8.5	"	6.0	70.7
06-30-63	"	"	"	"

Wellington Fund, Inc. 1928

06-30-39	8.0%	3.0%	5.0%	62.5%
12-31-39	"	"	"	"
12-31-40	"	"	"	"
06-30-41	"	"	"	"
06-30-43	"	"	"	"
12-31-46	"	"	"	"
12-31-48	"	"	"	"
12-31-51	"	2.0	6.0	75.0
12-31-53	"	"	"	"
12-31-55	"	"	"	"

12-31-58	"	"	"	"
12-31-60	"	"	"	"
12-31-62	"	"	"	"
06-30-63	"	"	"	"

EXHIBIT B

Memorandum

May 1, 1964

To: Gordon D. Henderson

From: Dennis J. Lehr

Subject: Mutual Fund Underwriting Costs: A Comparison With Certain Common Stock Data

Conclusion

Unless we assign arbitrary based for comparison between mutual funds and other companies, no definitive conclusions can be drawn as to whether the costs of flotation for mutual funds are generally higher than those for other companies. The assignment of such bases for comparison would involve decisions as to factors such as, the size of the offerings compared; the choice of non-fund industry; whether a "seasoned" or exchange-listed company or class of companies is compared; the respective factors that comprise the total "cost" of flotation of the respective issues; and the comparability of general market conditions prevailing in the periods studied.

1. SEC and NYSE Data on Costs of Common Stock Underwriting

The SEC's Cost of Flotation of Corporate Securities 1951-1955, among other information, provides data on 230 public offerings of common stock (excluding Reg. A offerings) which occurred during 1951, 1953 and 1955.[1] Samples were chosen from manufacturing (90), utility (40), communication (15), mining (55), and other industries (30).

The "cost" of flotation is expressed as a percentage of gross proceeds and consists of the underwriter's spread or commission plus the legal, printing, accounting and qualification (registration of blue sky) fees and other expenses. It does not include any value attributable to underwriter's options, etc. or stock bought below the offering price prior to the offering. The study found that on the average 85% of the total flotation cost represented compensation to underwriters and finders. The remaining 15% represented the other expenses of the offering which are customarily paid by the issuer. The study does not disclose what percent of the sampled issues were first offerings.

The common stock cost of flotation figures for all industries in the SEC study ranged from a low of 4.66% for offerings in the $10 million to $19.9 million class, to 27.15% for offerings in the under $.5 million class, with a median percent for all offering of 10.28%.[2]

The low, high and median figures for mining companies -the industry group having the highest flotation cost in the sample -were: 11.50%; 33.42%; 20.00%. The figures for the utilities -the industry group with the lowest flotation cost -were: 2.95%; 12.23%; 4.55%. Generally, for all the industry groups, the percentage cost of flotation decreased as the size of the offering increased, except that for offerings in the $20 million to $49.9 million class (the highest in the sample), the cost was higher than for issues in the $10 million to $19.9 million range.[3]

The New York Stock Exchange's Comparative Cost of Raising New Capital Through Common Stock, NYSE, Listed vs. Non-NYSE Companies 1958-1960, compared a select number of issues[4] of NYSE listed, companies with those not listed on that exchange.

The "cost" of flotation in this study consists of the underwriter's spread or commission but, unlike the SEC study, does not include expenses of printing, legal and accounting fees, etc. Also excluded from "cost" (although not specifically mentioned) are values attributable to underwriter's options previously purchased stock or finder's fees. The NYSE average costs are expressed as a percent of the net proceeds per share to the issuer, weighted by the value of the particular issue; whereas the SEC's study specifically observes that the median average, which it uses, is more meaningful because it avoids the weighting by large issues. The net effect then of the NYSE's approach is to understate average costs.

The relative costs of flotation among different industries is obscured in the NYSE's study because the size of the offering within any single industry are not specified. And where figures are given by size of issue, there is no industry breakdown.

For example:

Size of Issue	NYSE COMPANIES		OTHER COMPANIES	
(Million)	No. of Issues	Cost	No. of Issues	Cost
Under $5	12	4.90%	117	6.43%
$5 and under $10	26	4.13	29	5.22
$10 and under $20	23	2.43	9	4.79
$20 and over	25	2.40	4	6.09

The NYSE issues obviously are not first offerings, but no information is given for the other companies as to exchange listing or whether they made prior offerings.

In general, it may be suspected that in this study, companies were selected to establish the point "... that NYSE listed companies enjoyed significantly lower underwriting costs than non-listed companies."

2. Comparison to Mutual Fund Underwriting Costs

A comparison of the flotation costs between mutual funds[5] and of other companies offering securities to the public is difficult because of certain factors discussed below. We are left with a felt -- more than demonstrated -- difference in cost between a fund share and an offering of a high grade common stock.

Mutual funds must be prepared to constantly redeem their shares. From this fact, it may be argued that higher dealer inducements must be a factor in the flotation cost of funds to insure sufficient sales to avoid a net redemption situation -- a possibility not faced by other companies.

From the standpoint of the investor with $1,000 to invest in an equity security, the purchase of a fund will generally buy $920 of equity. As the SEC and NYSE studies show, $1,000 paid for any alternative publicly offered common stock investment will buy an equity interest which varies with the size of the issue, business of the issuer, exchange listing of the company, and other market condidtions.[6]

Whether fund underwriting costs compare favorably with the composite average of other company offerings also depends upon what is taken as the size of a fund offering. If we assume it is the dollar volume of sales in a day, week, or month, the "cost" of flotation may be well below a similar size non-fund or average of all issues.[7]

From the standpoint of the non-fund underwriter in "pricing an issue to market" he must take into account the amount needed to induce dealers to sell the issue and his own traditional expenses such as postage, telephone, legal and possibly accounting expenses. The mutual fund underwriter, on the other hand, traditionally pays certain expenses (taken out of his commission) that are not normally paid by non-fund underwriter. The fund underwriter normally must cover the costs of printing prospectuses, registration and blue sky fees, maintaining a staff of wholesale representatives pus the clerical force needed to service redemptions and the several accumulation, withdrawal or switching options that are offered.

[1] The Sample covers 50% by number and 60% by volume of all registered issues in the periods.

[2] Exhibit A, indicates the costs of common stock offerings by size of offering for all industries.

[3] The Report of the Special Study of the Securities Markets contains similar data for selected periods through 1961, with the added refinement of disclosing separate figures for companies that have made previous public offerings and for issues where additional non-cash compensation was received by the underwriter. See Exhibit B and C. The figures given are for "compensation" (underwriter's spread of commission) and consequently would have to be raiser by other expenses of the offerings in order to be comparable to the "cost" of flotation figures of the earlier SEC study.

As will be noted below, the "cost" rather than "compensation" figures are more meaningful when making comparisons with mutual fund flotation costs, because of the type of expenses assumed by the fund underwriters.

[4] The number of companies in the NYSE sample is quite limited and suggests that the selection may have been made to prove a point. There is no claim of a random sampling.

Year	NYSE No. of Issues	Other Company No. of Issues			
1960	19	68	1959	35	57
1958	32	34	1957	46	77
1956	53	51	1955	52	76

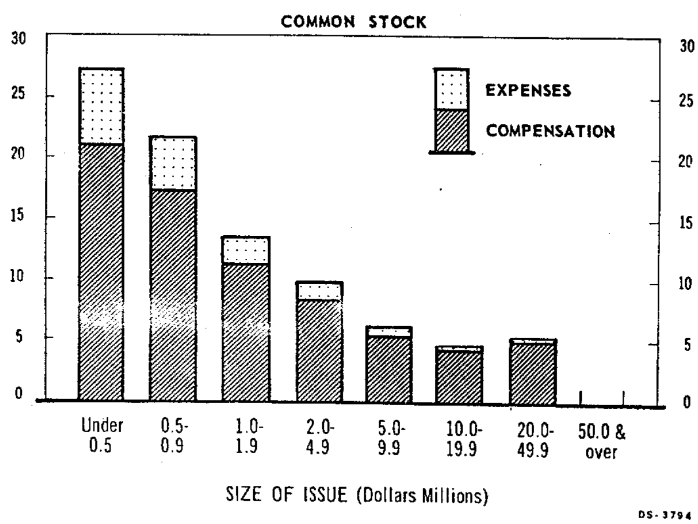
whereas in the SEC's fiscal year ended June 30, 1961, the number of registration statements that became fully effective covered 1,960 issues.

[5] "Cost" of fund underwriting is treated here an equivalent to sales load and expressed as a percentage of gross proceeds viz. -- offering price.

[6] Exhibit D shows the SEC study's data on the varying costs of flotation by type of company and size of offering.

[7] Also, the effective rate of sales load over, say one year, by virtue of volume discounts, results in a lower "cost" of flotation than the traditionally assumed 8.5%.

Ex. A.


COMMON STOCK
EXPENSES
COMPENSATION
30
25
20
15
10
5
0
Under 0.5
0.5-0.9
1.0-1.9
2.0-4.9
5.0-9.9
10.0-19.9
20.0-49.9
50.0 & over
SIZE OF ISSUE (Dollars Millions)
DS-3794

Ex. B

TABLE IV-22.—*Underwriters' cash compensation as percent of gross proceeds in common stock offerings by type of compensation and size of offering*

[Underwritten offerings for cash sale, 1949, 1953, 1960, and 1961]

Size of offering	All issues	Issues with cash compensation only	Issues with additional noncash compensation [1]
	1949		
Over $300,000, total [2]	6.4	6.2	28.0
$10,000,000 and over	4.6	4.6	
$5,000,000 to $9,999,999	6.5	6.5	
$3,000,000 to $4,999,999	6.4	6.4	
$1,000,000 to $2,999,999	9.4	8.7	28.0
$500,000 to $999,999	8.4	8.4	
$300,001 to $499,999	11.3	11.3	
$300,000 and under, total [2 3]	10.9	7.8	25.5
	1953		
Over $300,000, total [2]	5.8	4.8	15.8
$10,000,000 and over	4.2	4.2	
$5,000,000 to $9,999,999	3.6	3.7	1.1
$3,000,000 to $4,999,999	6.4	6.4	
$1,000,000 to $2,999,999	8.5	6.4	17.8
$500,000 to $999,999	10.9	9.3	15.4
$300,001 to $499,999	14.3	17.2	
$300,000 and under, total [2 3]	11.6	10.0	30.0
	1960		
Over $300,000, total [2]	9.4	7.9	12.7
$10,000,000 and over	4.4	4.4	
$5,000,000 to $9,999,999	6.2	6.1	6.8
$3,000,000 to $4,999,999	6.6	6.5	10.0
$1,000,000 to $2,999,999	9.1	8.8	10.6
$500,000 to $999,999	11.5	9.6	12.6
$300,001 to $499,999	15.4	12.5	16.4
$300,000 and under, total [2 3]	15.0	12.4	18.3
	1961		
Over $300,000, total [2]	9.6	8.0	12.3
$10,000,000 and over	3.2	2.9	6.8
$5,000,000 to $9,999,999	5.7	5.7	5.3
$3,000,000 to $4,999,999	7.2	7.0	9.5
$1,000,000 to $2,999,999	9.2	8.7	11.1
$500,000 to $999,999	11.8	9.9	13.0
$300,001 to $499,999	11.8	8.2	12.5
$300,000 and under, total [2 3]	15.2	11.6	16.4

[1] Refers to securities, warrants or options given in addition to the regular cash commission or discount. The value of this noncash compensation is not included.

[2] Median percentages. All other percentages are unweighted averages.

[3] Includes a small number of issues registered under the Securities Act of 1933 as well as issues exempt under regulation A.

NOTE.—Table includes issues registered under Securities Act of 1933 or exempt under regulation A.

Ex. C

TABLE IV-23.—*Underwriters' cash compensation as percent of gross proceeds in common stock offerings by seasoned and unseasoned issues, type of compensation, and size of offering*

[Underwritten offerings for cash sale, 1960-61]

Size of offering	Issues with cash compensation only			Issues with additional noncash compensation [1]		
	All issues	Seasoned [2]	Unseasoned	All issues	Seasoned [2]	Unseasoned
	1960					
Over $300,000, total [3]	7.9	6.2	9.1	12.7	8.7	12.9
$10,000,000 and over	4.4	4.4	—	—	—	—
$5,000,000 to $9,999,999	6.1	5.1	7.4	6.8	6.8	—
$3,000,000 to $4,999,999	6.5	4.2	8.7	10.0	—	10.0
$1,000,000 to $2,999,999	8.8	7.3	9.9	10.6	—	10.6
$500,000 to $999,999	9.6	9.2	9.8	12.6	8.2	13.2
$300,001 to $499,999	12.5	9.0	16.0	16.4	—	16.4
$300,000 and under, total [3] [4]	12.4	11.3	13.9	18.3	22.4	18.3
	1961					
Over $300,000, total [3]	8.0	6.4	8.5	12.3	12.6	12.0
$10,000,000 and over	2.9	2.5	4.6	6.8	6.8	—
$5,000,000 to $9,999,999	5.7	2.9	7.3	5.3	5.3	—
$3,000,000 to $4,999,999	7.0	6.8	7.2	9.5	—	9.5
$1,000,000 to $2,999,999	8.7	9.0	8.5	11.1	13.1	10.8
$500,000 to $999,999	9.9	8.4	10.5	13.0	12.7	13.1
$300,001 to $499,999	8.2	—	8.2	12.5	14.6	12.4
$300,000 and under, total [3] [4]	11.6	10.5	12.9	16.4	18.8	16.4

[1] Refers to securities, warrants, or options given in addition to the regular cash commission or discount.
[2] Defined for purposes of this study as stock of a company which was previously registered under the Securities Act of 1933 or regulation A, was listed on a stock exchange or had stock traded in other securities markets.
[3] Median percentages. All other percentages are unweighted averages.
[4] Includes a small number of issues registered under the Securities Act of 1933 as well as issues exempt under regulation A.

NOTE.—Table includes issues registered under Securities Act of 1933 or exempt under regulation A.

Ex. D

TABLE 4

Cost of Flotation
Registered Issues Offered to the General Public
Common Stock
Classified by Size of Issue and Industry of Issuer
1951, 1953 and 1955

Size of Issue ($ millions)	Manufacturing	Elec. Gas and Water	Communication	Mining	Other	All Industries
		Part 1. Number of issues				
Under 0.5	4	0	0	8	1	13
0.5 - 0.9	15	2	2	18	6	43
1.0 - 1.9	25	5	5	14	11	60
2.0 - 4.9	30	9	3	12	8	62
5.0 - 9.9	9	10	3	1	1	24
10.0 - 19.9	5	6	2	1	3	17
20.0 - 49.9	2	8	0	1	0	11
50.0 and over	0	0	0	0	0	0
Total	90	40	15	55	30	230
	Part 2. Cost of flotation as percent of proceeds					
Under 0.5	19.69	-	-	33.42	14.76	27.15
0.5 - 0.9	13.68	12.23	8.19	32.96	21.43	21.76
1.0 - 1.9	12.84	6.52	5.98	22.18	11.53	13.58
2.0 - 4.9	8.61	5.42	5.76	17.71	12.88	9.97
5.0 - 9.9	6.38	4.53	6.68	12.33	14.28	6.17
10.0 - 19.9	4.88	2.95	5.08	11.50	6.60	4.66
20.0 - 49.9	5.48	4.20	-	15.63	-	5.37
50.0 and over	-	-	-	-	-	-
Total 1/	10.06	4.55	6.07	20.00	12.26	10.28