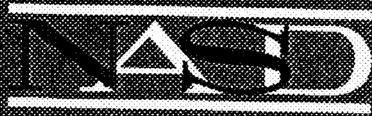

SPECIAL REPORT
TO NASD MEMBERS

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., 888 17th ST. N.W., WASHINGTON, D. C.

May 1967
SR-1

Summary Of The NASD Study Measuring The Impact On The Securities Business Of SEC Mutual Fund Recommendations

Introduction

The 3,600 members of the National Association of Securities Dealers will suffer a drastic loss of income and a great many firms may be forced to leave the business should the proposals of the Securities and Exchange Commission, legislative and otherwise, relating to open-end investment companies (mutual funds), actually take effect.

Moreover, it appears that there could be significant reductions in the profitability of the comparatively small mutual fund transaction so that large numbers of potential investors may no longer have this important investment medium brought to their attention. Salesmen who now find it worthwhile to seek out investors with modest means, to the point that the average mutual fund share purchase today is $1,240, may no longer be able to afford to offer this unique type of security to those investors who perhaps need it the most.

These are the basic findings of a study authorized by the Board of Governors in January, 1967, to determine the probable economic consequences of the SEC proposals.

The Commission originally proposed alterations in all essential elements of mutual fund management and distribution. The NASD study was confined to those areas in which the Association is most intimately involved; the various proposals affecting distribution.

These were (1) that sales charges be reduced by approximately 40 percent or to about 5 percent of net asset value; (2) that the traditional system of reciprocity be substantially altered by elimination of customer-directed give-ups (or commission sharing) on investment company portfolio transactions; (3) that the so-called front-end load on periodic payment contractual plans be eliminated; and (4) that the sales charge on reinvestment of income dividends be eliminated.

These recommendations obviously could have an important effect on the several elements of the securities business that participate in them, particularly in the light of the growth of the mutual fund business since enactment of the Investment Company Act in 1940. At that time, mutual funds had total assets of some $450,000,000 owned by 300,000 shareholders. Today 3½ million shareholders hold total mutual fund assets of about $37 billion.

Some 3,600 NASD broker/dealers employ about 90,000 salesmen, nearly all of whom at some time or other sell mutual fund shares to their customers. These firms and their salesmen are located in every state and, while mutual fund home offices traditionally have tended to be concentrated in a relatively few major financial centers, today there are management companies on both coasts and in many major cities in between.

Thus, there is hardly a segment of the financial community that in some way would not be affected by the proposals for far-reaching changes set forth by the Commission in its report on "The Public Policy Implications of Investment Company Growth."

With the authorization of the Board of Governors, the consulting firm Booz-Allen Applied Research, Inc., was retained by the Association to draw a scientifically structured sample of NASD

members from among the 2,400 member firms participating in the 1965-66 study of the OTC market. This sample was designed in a manner to approximate the characteristics of NASD members engaged in distributing mutual fund shares as to size of firm and type of business.

In all, 195 firms were selected to receive a questionnaire developed by a Special Study Committee in consultation with many leading persons in the business, and completed questionnaires were received from 185 of these firms.

This questionnaire was designed to ascertain on a dollar basis as much information as seemed reasonably possible about the overall business of each firm and its salesmen in relation to mutual fund sales and other activities. In all cases actual 1966 income and production figures were obtained and applied under assumption that the SEC proposals were in effect during this same period. Questions also were asked as to amount of time expended in making sales, in servicing accounts, etc., as well as opinions on firm profitability as result of possible implementation of the SEC proposals.

On the basis of the results of the survey, set forth in brief detail below, it is obvious that the proposals of the Securities and Exchange Commission, if implemented, would have extremely severe adverse economic effect on a substantial portion of the Association membership.

Survey Findings

A careful analysis of the financial information supplied by 185 NASD member firms surveyed in connection with the Association's Impact Study has revealed that almost one-half of those firms that were profitable in 1966 would be thrown into a net loss position if Congress adopted the SEC's mutual fund proposals.

Most striking, responding firms in the sample which fell into gross income groups of under $200,000 for 1966 would suffer aggregate losses of almost 335 percent in net income after taxes. More than 100 firms whose gross income in 1966 was under $100,000, would experience reductions in net income after taxes of more than three times if all the SEC proposals were put into effect. Seventeen firms in the $100,000 to $200,000 gross income category would feel an even more dramatic impact from the SEC proposals by having their net income reduced almost four times. The next category of 41 firms in the sample, those with gross income between $200,000 and $2,500,000, would find their net income after taxes reduced by more than half under the SEC recommendations. The largest 26 firms in the sample, those with gross income over $2,500,000, would experience net income reductions of approximately 8 percent in total.

These figures result from precise calculations made by Booz Allen, on a firm-by-firm basis using financial data supplied for 1966. The calculations assume that no change would occur in the volume of transactions with respect to mutual fund business, although it is very likely that lower sales compensation would materially reduce incentives to sell mutual funds and thereby compound the effect of the SEC proposals.

These figures were drawn from a scientifically constructed sample representing a majority of the NASD membership, and when expanded to the total universe, a graphic picture emerges of extreme loss in profitability for more than half of the Association's members and possible inability to survive under the SEC mutual fund proposals for many other firms.

The NASD Impact Study showed that the proposed lowering of the sales charge on mutual funds to 5 percent would have the most severe impact of any of the SEC recommendations. Taking the sales charge alone, the reduction in net income after taxes for all firms in the sample would amount to $3,630,000 or 22.7 percent. This aggregate figure masks the fact that the impact would be much more severe on the firms relying heavily on mutual fund business, which are generally the smaller firms.

Taking the proposed elimination of reciprocal give-ups alone, the NASD Impact Study showed that 172 firms out of 185 would suffer loss of income. Most important, however, is the simultaneous changing of profit distribution within the industry as a result of the elimination of give-ups. Because 13 of the largest firms in the sample paid out by way of give-ups considerably more than they received from this source, the elimination of give-ups would substantially shift profits from the smaller and medium size firms to the largest firms in the sample, thus further concentrating profits with the larger organizations in the securities business. This point is illustrated in the NASD study by the

fact that in the aggregate for 185 firms included in the sample, elimination of give-ups in 1966 would have resulted in a slight increase in net income after taxes.

As previously pointed out, the group of largest firms in the NASD survey would suffer only an 8 percent loss in net income as a result of enactment of all SEC proposals, while the smaller firms would have net income after taxes reduced by more than three times. Of these smaller firms operating in the black before the SEC proposals, three-fifths would be forced from a profit to a loss position. Thus, it is obvious that many, if not most of these firms, would be forced out of business by the SEC proposals, and this assumption can be projected to the entire universe of NASD members from which the sample was drawn.

As expected, the severity of the impact of all the SEC mutual fund recommendations varied directly with the degree of a firm's concentration in the mutual fund business. One-third of the reporting firms fell into a group where 90 to 100 percent of their business was concentrated in mutual funds. For this group the degree of loss in net income after taxes would have amounted to 240 percent, and one-third of the total reduction in net income after taxes for all firms would have been borne by those in this high mutual fund concentration category.

The Impact Study showed that firms whose mutual fund activities accounted for 30 to 50 percent of their business would experience an 85 percent reduction in income under the SEC proposals. Firms whose mutual fund concentration was 50 to 70 percent would experience a 149 percent reduction in income. In other words, firms whose mutual fund business accounted for half or more of their total business would in the aggregate be thrown from a profitable position into a loss situation. Obviously these are the firms who are least able to stand such drastic reductions in income. Of the 78 firms whose net income after taxes would have been reduced by more than 100 percent, 43 fell into the class showing the greatest degree of concentration in mutual fund business.

One interesting fact disclosed by the survey is the contrast between the reduction of 3.3 percent in the aggregate that would be felt by the 24 firms that hold membership in the New York Stock Exchange, the American Stock Exchange and other stock exchanges, and the 126 percent loss that would be suffered by the 118 firms that held no exchange memberships. This latter group accounted for nearly two-thirds of the number of reporting firms in the sample. Nearly three-fourths of the total reduction in net income would be borne by non-New York Stock Exchange members. In part, these contrasts arise from the net flow of give-up payments from diversified firms to those heavily concentrated in mutual fund distribution. Of the 78 firms that would have suffered more than a 100 percent reduction in net income, 62 held no exchange membership. On the other hand, two of these firms held memberships in the New York Stock Exchange, American Stock Exchange and other exchanges.

The Impact Study illustrated that largely because of give-up flow the group of firms located in New York City would have benefitted from a slight increase in net income after taxes if all of the SEC mutual fund recommendations had been in effect for 1966. However, the group of 34 firms having their main offices located in the next ten largest cities would have had their total net income after taxes reduced by slightly more than one-fourth. Firms in other locations, accounting for about two-thirds of all reporting members, would have had their total net income nearly cut in half by the SEC proposals. Of the 78 firms that would have suffered reductions in net income of 100 percent or more, 62 are not located in New York City or even in the next ten largest cities.

While the foregoing summary discussion relates to the effect that the SEC proposals would have on the profit of firms, equally important is the economic impact that would be absorbed by registered representatives.

The Impact Study indicated that overall 64 percent of the full-time, non-management registered representatives with member firms in the sample earned less than $15,000 in 1966; and 77 percent earned less than $20,000 during the year.

The income of such full-time registered representatives employed by medium and smaller firms is even more modest. Eighty-two percent of such registered representatives with firms whose total gross income falls between $200,000 and $2,500,000 earned less than $15,000 in 1966 and 90 percent of those salesmen with firms in the smaller gross income category ($100,000 to $200,000) earned less than $15,000. The NASD study showed that registered representatives employed by firms least

dependent upon mutual fund sales generally have higher incomes than those men working for firms specializing in mutual fund shares.

Such relationships indicate that the major impact of any reduction in mutual fund sale charges will fall most heavily upon registered representatives least able to suffer a loss in income and survive in the securities business.

One of the most important factors in the structure of compensation for selling mutual fund shares is the longevity of this type of investment. The Impact Study showed that 60 percent of mutual fund investors hold their shares for over ten years. More than one-fourth held shares from five to ten years, and 12 percent were in the one to five year category. Less than 1.5 percent of investors eliminated their mutual fund holding before a year had passed. These figures strongly refute any suggestion that mutual fund shares are not purchased and held for long-term investment.

A reduction in mutual fund sales compensation will present many salesmen with the choice of either leaving the securities business or diverting their sales efforts to other types of securities suitable for trading accounts. However, not all firms employing registered representatives have the facility to shift to a general securities business and, consequently, the salesmen of these firms would have to seek a new employer.

The level of compensation earned by registered representatives must also be related to the skill and talents that are needed of those in the securities business. Both talent and knowledge are required for those who seek to advise and assist others in the investment of savings, and they must undergo extensive training. Training has become a significant cost factor to employers as well as to trainees. The present level of remuneration earned by the majority of registered representatives is not sufficiently high to permit such a substantial reduction as forecast under the SEC proposals without a marked deterioration in the calibre of the average registered representative meeting the public, according to the NASD Impact Study.

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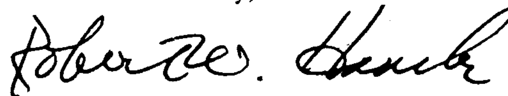
Sincerely,



Robert W. Haack
NASD President

Note: Quantity copies of This Special Report are being sent to all NASD members for distribution to registered representatives.