of payments actually received from the planholders of those accounts. It concludes, on an aggregate basis, that—

> Although a small percentage of the accounts opened in 1953, in 1954, in 1955, and in 1956 are delinquent in payments, those opened the last 5 years are ahead in their scheduled payments. As a result, less than 2.5 percent of all 26,981 accounts were behind in payments at the end of 1962.[224]

The table from which the AMFPS concluded that "less than 2.5 percent of all * * * accounts" were behind in payments at the end of 1962 sets forth for plans sold in each year the amount of aggregate payments scheduled and the amount of actual aggregate payments made. Where aggregate scheduled payments exceeded aggregate actual payments made (as was the case for plans sold in 1953–56) an "Aggregate Amount of Delinquent Payments" is shown. Conversely, if aggregatae actual payments during the year exceeded aggregate scheduled payments (as was the case for plans sold in 1957–62), the net balance is reflected as an "Aggregate Amount of Prepayments."

The "less than 2.5 percent" is computed by dividing the total of "Aggregate Amount of Delinquent Payments" (which reflects plans sold in only 4 years) by the total of "Amount of Aggregate Payments per Schedule" (which covers plans sold in all 10 years). No consideration is given to the *number of accounts* in each of such years that were either delinquent in, or ahead of, scheduled payments. The data presented therefore cannot support any conclusion concerning the number or percent of accounts behind or ahead of schedule, since relationships in the table are in terms of net dollars. The AMFPS notes that its comparison "can only provide a clue to whether plan payments are running ahead or behind schedule generally."

AMFPS then proceeds to examine the 1,235 accounts opened in 1962 to confirm the fact that for these plans actual payments made by December 31, 1962, amounted to $745,500, compared to scheduled payments of $370,500. An analysis of these 1962 figures suggests the extent to which prepayments may result in planholders' running ahead of schedule. Approximately 27.8 percent of the plans purchased in 1962 had paid 13 or more installments at the year's end. This 27.8 percent had made advance payments by the end of the year of purchase and had paid 55.2 percent of total actual payments. The 72.2 percent of accounts which had made 1 to 12 payments, some of which may also have been prepaid, had paid 44.8 percent of actual payments. In view of the encouragement given to planholders to make substantial prepayments with their initial payments, and the incentive to salesmen to obtain such prepayments, it is possible that the high percentage of accounts prepaid in the year in which they were initiated represented a large portion of those who were ahead of scheduled payments.

The final group of AMFPS data shows the number of accounts of one sponsor that completed payment in each of the years 1958 through 1962 and the first quarter of 1963 and the number of accounts opened 10 years previously. The percentage of completions, not reflected in the AMFPS supplement,[225] ranges from a low of

[224] Origin and History, 1963 supplement, p. 7.
[225] Origin and History, 1963 supplement, p. 9.

58.1 to 88.2 percent except for one year when the percentage completed exceeded 100 percent (112.4 percent). It is explained by footnote that this "was due to the acceleration of payments. Acceleration may also have occurred in some of the other years shown." [226] In view of this fact and of the likelihood that the completion percentages also include accounts which took more than 10 years to complete payments, the number of accounts completed in any year does not accurately reflect the completion percentage of accounts opened 10 years previously. The cause of this distortion (i.e., that plan completions in a given year are not necessarily only those of plans initiated exactly 10 years previously but may include plans initiated before or after the start of the 10-year period) is eliminated in the Waddell & Reed, Inc., statistics presented below since they reflect the completion record of accounts opened in specific years.

Despite the limitations of the AMFPS statistics and the dubious assumption that aggregate net profits and losses of redeeming planholders are the proper criterion for evaluating the impact of the front-end load, regardless of the percentage of investment paid as sales charges by the individual planholder, the NASD relied, in 1961, on the AMFPS' statistics and that assumption in rejecting a suggestion that it adopt a rule or interpretation requiring that the front-end load portion of the contractual plan sales charge be extended over the first 24 rather than the first 12 payments. A report to the Board of Governors from the NASD Investment Companies Committee noted that the suggestion was "presumably based on the assumption that cancellations in the first few years of plans are high and that the average loss suffered from cancellation is large." The report then cited the same statistics which AMFPS has published and which have been discussed above, relating to the percentages of purchasers redeeming with losses in the early years of the plan, and concluded that to spread the front-end load portion of the sales charge over 24 rather than 12 payments "would affect an average of only about 1 percent of accounts opened," and would make "relatively little difference in the penalty" by the end of the second year. In reaching this conclusion the report failed to consider that the percentage of sales load to investment is a function of number of payments rather than time, or the effect of the front-end load on contractual plan purchasers whose accounts became inactive prior to payment of 24 installments but were not redeemed. It did, however, consider the impact of the proposal on contractual plan sponsors, noting:

> It should be added that few, if any, plan sponsors realize profits from a plan in its early months. One plan sponsor's analysis indicated that, after direct and indirect costs are applied, it will not reach the "break-even" point on accounts until the eighth or ninth monthly payment has been completed. Any action to extend the present sales charges to cover the first 24 monthly payments would aggravate this condition.

(3) *The Waddell & Reed, Inc., statistics*

Waddell & Reed, Inc. (W. & R.), a large contractual plan sponsor, also submitted to the study an analysis of the history of all accounts opened during the period from 1949 to April 30, 1962, for contractual plans in the United Accumulative Fund. The study reflects, for each

[226] Ibid.

year from 1949 through 1961 and for the first 4 months of 1962: the total number of accounts opened; the number of accounts terminated with a net gain to the investor and with a net loss to the investor, and their aggregate payments and aggregate realization; the number of nonterminated accounts (labeled by W. & R. as "active"), their aggregate payments and their aggregate net asset value as of April 30, 1962. In these respects, the presentation of the statistics is similar to the AMFPS figures discussed above. However, the W. & R. study is more comprehensive than the AMFPS statistics in providing a breakdown of the number of installments paid through April 30, 1962, on plans of each size. The W. & R. study is the only information the Special Study has reflecting the status of contractual plan accounts in terms of the number of installments paid at about the time of scheduled account completions.[227]

In order to examine the percentages of installments paid by plans which in accordance with their schedules might have been expected to be completed, the study reviewed the payments records as of April 30, 1962, of all W. & R. $25, $50, and $100 per month accounts sold during each of the years 1949–53.[228] The W. & R. contractual plans are scheduled for completion at the end of 8 years by means of an initial five-installment payment plus the payment of one installment in each of the following 95 months. As a result, April 30, 1962, represents a point in time which ranges from 4 months to 5 years beyond the completion dates of accounts sold in 1949–53. The statistics indicate that, as of April 30, 1962, for W. & R. contractual accounts sold during each of the years 1949–53, and which, according to the payment schedule should have been completed, the percentage of installments paid was as shown in the following table:

TABLE XI–g.—*Percent of plans purchased in 1949–53, inclusive, paying the installments by Apr. 30, 1962*

Year of purchase	Number of installments paid		
	35 or less	47 or less	100 (completion)
1949	22.0	27.5	55.8
1950	29.3	35.9	47.6
1951	27.7	36.5	47.5
1952	30.8	37.8	46.3
1953	31.1	37.8	44.7

h. Comparison of performance of contractual plan and voluntary plan investors

Members of the contractual plan industry place emphasis on the assertion that the performance record of investors in contractuals is far superior to that of investors in voluntary plans. For example,

[227] In connection with the W. & R. study it may be noted that in the Special Study's sampling of the payment records of contractual plan accounts initiated in 1959, W. & R. accounts had achieved a substantially lower redemption rate on incompleted accounts than the other eight contractual plans in the sampling, but the second highest percentage of lapsed accounts. The W. & R. total of redeemed and lapsed accounts approximated the average of all plans sampled.

[228] The study thus selected plans sold in the first 4 years out of the 12-year-and-4-month period covered by the W. & R. statistics, involving 97.4 percent of all W. & R. contractual plans sold during the 4 years.

Arthur Wiesenberger & Co. in its annual book on investment companies states:

> Experience has demonstrated, beyond any doubt, that regular investing will be maintained by a far higher proportion of contractual planholders than of investors who use informal accumulation plans or "open accounts." The so-called "penalty" appears to work, as it does with life insurance, to minimize lapses in payments.[229]

Only three records of data on the performances of voluntary plan investors are known to the study. One of these was prepared by the AMFPS, another by Putnam Fund Distributers, Inc., and the third was submitted to the Commission by W. & R. in 1960.

(1) *AMFPS statistics*

In "The Origin and History of the Contractual Plan" the AMFPS notes that beyond reporting monthly the number of new accounts started and the number terminated, no serious attempt has been made by underwriters to evaluate the lifespan of voluntary plans. It adds, however, that certain investment dealers keep track of their sales of voluntary plans, and reports a statement of one such dealer indicating that of 604 plans sold by him from January 1955 through December 31, 1958, the number of planholders who made payments in 1959 ranged from 27 percent of those sold in 1955 to 56 percent of those sold in 1958. The AMFPS also notes with respect to the New York Stock Exchange monthly investment plan (MIP), described by it as a "type of so-called 'voluntary' plan," 50.1 percent of the 163,000 accounts started between January 1954 and December 1958 had either terminated or completed payments by December 31, 1958.

With these fragmentary figures, the AMFPS makes no attempt at a statistical comparison of the performance of purchasers of contractual and voluntary plans.

(2) *The Putnam Fund Distributors, Inc., statistics*

A voluntary plan with completion insurance has been offered by this organization since 1954. Of all such voluntary plans sold from that time until the end of May 1963, 85.4 percent have without fail made regular monthly or quarterly payments (as indicated on their application) of no less than $50 since they joined the plan. When a payment becomes 31 days overdue, the insurance coverage lapses and the plan is terminated. Upon completion, planholders may join another Putnam voluntary plan (one without completion insurance) or may obtain a certificate for their accumulated shares or the cash value thereof. Reinstatement of the voluntary plan with completion insurance is allowable, under certain conditions, within a year.

These statistics do not reflect the number of voluntary plans with completion insurance purchased each year nor the payment records for plans initiated in each year from 1954–63. In addition, the statistics may include planholders whose insurance has lapsed through nonpayment but who have subsequently been reinstated within 1 year as permitted under the contract. Despite their inconclusive nature, the statistics seem to indicate a very high proportion of systematic payments, even when compared to the insured contractual plan accounts of denominations of $50 per month and over in the study's IC–8 sampling of which, 3½ years after they were begun,

[229] Investment Companies, 1963 edition, p. 59.

9.8 percent had redeemed, 9.0 percent were lapsed and 5.3 percent had been reactivated after having made no payments for 12 or more months.

(3) *The Waddell & Reed, Inc., statistics*

In October 1960, W. & R. submitted to the Commission a study of the record of performance and persistence on "United Systematic Investment Programs" (voluntary plans) to acquire shares in United Accumulative Fund which are sold by it. W. & R. selected the first 1,000 account numbers of voluntary plans sold in each of the four States, California, Michigan, Illinois and Ohio, which were selected for the study because they limited or prohibited the sale of contractual plans. The 4 States produced, after cancellation of 124 account numbers, 3,876 accounts for study. The periods during which the plans were sold varied in the different States as follows:

Michigan	1951–55	Illinois	1950–55
Ohio	1951–56	California	1950–53

Selection of voluntary plans from these four States which limited or prohibited sale of contractual plans was for the purpose of removing the possibility of a bias resulting from presentations by salesmen favoring the contractual plan.

The status of these 3,876 voluntary accounts, initiated at various times between 1950 and 1956, as of June 30, 1960, was compared with the records as of the same date of payments on the 43,802 contractual plans sold by W. & R. during the same period, with results summarized by W. & R. in the following table:

TABLE XI–h.—*Review of payments on accounts in United Periodic Investment Plans and United Systematic Investment Programs (as prepared by Waddell & Reed, Inc.), 1950–56*

Number of payments made	Contractual plans [1]			Voluntary plans [2]		
	Number of accounts	Percent of total accounts	Cumulative percent of total	Number of accounts	Percent of total accounts	Cumulative percent of total
1	1,668	4	4	845	22	22
2 to 12	6,390	15	19	1,776	46	68
13 to 47	13,382	30	49	952	24	92
48 to 95	10,434	24	73	274	7	99
96 and over	11,928	27	100	29	1	100
Total	43,802	100		3,876	100	

[1] "Periodic Investment Plans."
[2] "Systematic Investment Programs."

NOTE.—Periodic Investment Plans with face amounts of $25,000, $50,000, and $100,000 are not included in this schedule because fully paid plans in these denominations are completed in 91 payments. During the period under review, 79 such plans were sold.

As of June 30, 1960, 42 percent of the voluntary plan accounts had been terminated, in contrast to 27 percent of the contractual plans sold during the same period, 1950–56.

The breakdown of the 58 percent of the voluntary plans that were still open on June 30, 1960, shows that—

on 18 percent no payment had been made within 5 years,
on 12 percent no payment had been made within 3 years,
on 10.5 percent no payment had been made within 1 year, and
on 16.8 percent payments had been made within 1 year.

The W. & R. data do not reveal the comparative percent of contractual plan accounts that had or had not made payments during these same periods, but it does reveal that a substantial percentage of contractual plans sold by it during these same periods were well behind in scheduled payments as of June 30, 1960. Of the $25, $50, and $100 monthly contractual plans sold by W. & R. between 1950 and 1956 (97.8 percent of all contractual plans sold by it during those years), the percentages of accounts which had paid 35 or fewer installments as of June 30, 1960, were as follows:

TABLE XI-i.—*Percent of plans purchased 1950 to 1956, inclusive, paying 35 or fewer installments at June 30, 1960*

Plans bought in—	*Percent having paid 35 or fewer installments*
1950	29.4
1951	30.6
1952	32.1
1953	32.4
1954	33.2
1955	37.3
1956	38.3

Since the number of months in which installments could have been paid on these plans at June 30, 1960, ranged from 42 to 126,[230] it is likely that some percentage of the contractual plan purchasers of earlier years, like the voluntary plan purchasers referred to above, had made no payments during 1, 3, and 5 years prior to June 30, 1960.

The value of the comparison of performance records of 3,876 voluntary plan purchasers and 43,802 contractual plan purchasers is also diminished by the fact that "payments" as used by W. & R. in the voluntary plan statistics means the actual number of payments made, without regard to the size of the payments, while as used by W. & R. in the contractual plan statistics the term refers to the number of installments paid, not the actual number of payments. For example, if $1,000 were invested initially, it was counted as a single payment in the case of a voluntary plan, but in the case of a $25 monthly contractual plan it was counted by W. & R. as 36 payments—$125 as the required initial 5-unit payment and $875 as an additional 35 payments of $25 each. The W. & R. percentages of number of payments made by contractual planholders and voluntary planholders are therefore not comparable. A different perspective on the W. & R. figures may be gained from the fact that total payments were $8,974,319 by June 30, 1960, on the 3,876 voluntary plans opened between 1950 and 1956, or an average of $2,315 per account, compared to a total of $98,758,250 or an average of $2,255 per account for the 43,802 contractual plans opened in the same period. The average payment on voluntary plans on which only one payment was made was $984, compared to five required initial installments totaling $125 on $25-a-month plans, $250 on $50-a-month plans, and $500 on $100-a-month plans.

[230] There are 126 months between Jan. 1, 1950, and June 30, 1960, but W. & R. contractual plans call for only 96 installments: a first installment of five times the monthly payments plus 95 additional payments. The 42 months represent the period between December 1956 and June 30, 1960.

(4) *Evaluation of comparisons of performance of contractual planholders and voluntary planholders*

Despite the contractual plan industry's emphasis on the superior performance of contractual plan purchasers, who are claimed "to achieve a much lower rate of cancellation," [231] there seems to be little significant statistical information known to the study which relates to that conclusion. In any event, it should be noted that comparisons of systematic payment records and lifespans of voluntary and contractual plan accounts ignore both differences between the two types of plans quite apart from the penalty and differences in the objectives of the purchasers of the two types of plans, which factors may significantly affect investors' payment records.

Except for the few voluntary plans that are sold with completion insurance, voluntary plans are generally sold without a fixed "goal" or "schedule" of payments.[232] For example, voluntary plans do not provide for total payments of $3,000 to be achieved by paying $25 per month for 10 years. Very often they are sold merely as a means of obtaining automatic reinvestment of dividends. Moreover, voluntary planholders are not "locked in" by the front-end-load penalty. While the penalty of the front-end load may induce the contractual plan purchaser to continue to invest in *that* contractual plan, the voluntary planholder, not having paid sales charges of over 8.5 percent, has greater freedom to invest in other mutual funds or other types of investments. If his record of systematic payments on his particular voluntary plan is poorer than that of the contractual plan purchaser, it does not necessarily indicate that he is investing less. It may mean that he is not systematically investing in that particular mutual fund.

Second, factors other than the penalty of the front-end load may account for differences in the systematic payment records of voluntary and contractual plan purchasers. Completion insurance, which is offered on W. & R. contractual plans but not on their voluntary plans, is indicated by the Special Study sampling to be a factor in producing a good record of systematic payment. The AMFPS, in discussing lapsed contractual plan accounts, gives recognition to the fact that completion insurance has a favorable effect on planholders in maintaining payments.[233] Since the W. & R. figures do not indicate which of its contractual payment accounts were sold without completion insurance, a comparison between the voluntary plans and uninsured contractual plans in the W. & R. study is impossible.

The dubious basis for any comparisons of contractual and voluntary planholders' performance records does not appear to inhibit sponsors and salesmen from making comparisons which favor the contractual plans, despite the AMFPS' statement in 1959 that no serious attempt had then been made to evaluate the lifespan of voluntary plans and its failure to indicate that any such attempt has since been made. Neither the AMFPS Code of Business Practices, which provides a code of ethics for AMFPS members, the

---

[231] Origin and History, p. 14.

[232] Hugh L. Jamieson, president of King, Merritt & Co., in testifying about the voluntary plan, said that it "* * * is not sold as a plan. It has no maturity date * * * no goal, no objective. It has no number of payments. It doesn't have fixity of purpose. It is a place to deposit money where you have some left over." But see Putnam Fun Distributors, Inc., statistics at 7.h(2), above.

[233] Origin and History, 1963 supplement, p. 6.

Commission's Statement of Policy covering the sale of mutual fund shares, nor any interpretation by the NASD of its Rules of Fair Practice requires the disclosure to a contractual plan purchaser other than by prospectus of the existence of voluntary plans. A number of firms, however, use training courses which teach salesmen to disclose the existence of both types of accumulation plans, and how to persuade the prospect to choose the front-end-load method. For example, the Kalb, Voorhis CMFR course states:

> It is vital that you make clear to your prospect that there are two methods of systematic accumulation fund shares * * * the "voluntary plan" and the "prepaid charge" or contractual plan. Not only is it to your own selfish interest to make sure your prospect is aware of the "voluntary" alternate, but it is your ethical and legal responsibility to do so.

The contractual plans sales training course prepared for King, Merritt & Co. by Arthur Wiesenberger & Co. does not specifically instruct the trainee that he must advise the client of the alternate level-load plan, but does treat the handling of possible objections to the front-end load in a manner similar to that found in the Kalb, Voorhis course. Both stress the penalty as a selling point and both furnish the salesman with information concerning the completion rate on contractual plans that is substantially at variance with data known to the study.[234] For example, the Kalb, Voorhis CMFR course, after admitting that "it is difficult to obtain completion figures that have real meaning," nevertheless arrives at alleged completion statistics as follows: "Based on the liquidation figures, the completion rate of contractual plans seems to lie somewhere between 80 and 90 percent." The Wiesenberger course instructs the salesman to advise his client as follows:

> Do you know that 90 percent of the investors who try the Voluntary Plan method of monthly buying without penalty *fail* to carry their Plans through the 5th or 6th year? On the other hand, 90 percent of Contractual Plan Investors complete their plans because the Penalty taught them the habit of Monthly Purchase.

i. Evaluation of front-end load

The typical contractual plan purchaser, as shown by the Mutual Fund Investor Survey, is a person of modest means and heavy responsibilities. The ranks of the purchasers include a high representation of men with annual incomes between $5,000 and $10,000 who are married and heads of families with three dependents. To such purchasers, even a small investment can have major importance to their financial welfare. Most of them when they purchase contractual plans are making their first investments in corporate equities. Among redeemers of contractual plans, the use of mutual fund shares as a source of "rainy-day" savings is clearly evident.

The Investment Company Act, which governs contractual plans, is in important respects a regulatory statute which extends protection of investors beyond that generally provided by the Federal securities laws. It does not confine itself to requiring disclosure, leaving the interest of the investor entirely to his own judgment or its protec-

[234] The statistics submitted by W. & R. show that by Apr. 30, 1962, of plans purchased in 1949–53 inclusive, completions ranged from 44.7 to 55.8 percent. AMFPS data as to accounts of one sponsor that completed payments in 1957–61 and part of 1962 (in relation to member accounts opened 10 years earlier) gives a percentage completion range of 60 to 90 percent. However, these percentages are distorted in that the plan completions in a given year are not necessarily only those plans initiated exactly 10 years previously, but may include plans initiated before or after the start of the 10-year period.

tion to his own action. In connection with periodic payment plans, and more specifically the front-end load, the Congress in section 27 of the act imposed protection provisions not limited to assuring the investor of "adequate, accurate and explicit information, fairly presented." [235] For example, in establishing a maximum sales load of 9 percent and providing that no more than one-half of any of the first 12 monthly payments, or their equivalent, be deducted for sales load, it provided the only specific Federal statutory limitation on security selling charges.[236]

It is clear that the front-end load is a mechanism under which the purchaser is called upon to finance in advance the selling effort which goes into the distribution of fund shares. The contractual plan industry is not unique in this respect. As James M. Landis, chairman of the AMFPS, has pointed out, "The sale of life insurance has the same problem and meets it essentially in the same way." [237] But life insurance as an investment medium differs from mutual funds in important respects, and in any event its sale is not the direct concern of the Commission or the Federal securities laws. In view of the protective nature of the provisions of the Investment Company Act and the type of investors to whom many contractual plans are sold, it is appropriate for the Commission to consider whether this mechanism under which the purchasers finance the sellers is justified by the benefits conferred upon the purchasers by the sellers.

Industry justification of the front-end load itself, as distinguished from mutual funds generally, rests as has been seen on three arguments: on the whole, few people lose money; the front-end load is a necessary stimulus to regular investment; and the arrangement is necessary to compensate salesmen and sponsors adequately. Each of the arguments has its limitations.

Arguments based upon the "small" number of terminations with losses (even assuming that the AMFPS rate of about 15.8 percent over a 5-year period is viewed as "small") ignore the fact that the reasonableness of sales charges is generally determined in relation to the amount invested, and it is cold comfort to the investor who has paid a sales charge equal to 50 percent of the amount paid in (or 100 percent of the amount invested on his behalf) to know that some others have invested profitably. The Special Study's review of the performance of February 1959 plan purchasers 3½ years later shows that fully 16 percent of purchasers were in the group of redeemed or lapsed planholders who had paid a 50-percent sales load, while over 25 percent of all purchasers had redeemed or were lapsed, having paid a sales load of 25 percent or more.

The argument that the front-end load provides a necessary stimulus to regular investment, heavily and successfully relied on as a sales argument, raises several questions. Even assuming that contractual planholders develop successful savings habits, for many of them a fixed goal and schedule of payments, regular reminders and the concomitant purchase of completion insurance (none of which is related to the front-end load itself) may be as important stimulants as the penalty involved in the load. Voluntary plan distributors have found

[235] Investment Company Act, sec. 1(b)(1).
[236] Under sec. 22(c) the Commission is empowered to adopt rules governing the sale of mutual fund shares in order that the price at which they are offered does not include an unconscionable or grossly excessive sales load.
[237] Origin and History, p. 25.

it possible to provide an effective stimulant through the use of such devices as postdated checks or agreements authorizing future drafts on the planholder's bank.[238] However, the Special Study analysis of the performance record of February 1959 contractual plan purchasers casts a shadow on the underlying assumption, in revealing that 3½ years later 36.9 percent of such purchasers had clearly not persisted as systematic, regular savers, while some portion of active accounts appeared not to be regular in their payments, to the point where they could only be called occasional investors.

The argument that the front-end load is necessary to compensate salesmen and sponsors adequately tends to beg the question of whether the merits of contractual plans are sufficient to justify the impact of the front-end load on purchasers who fail to complete their plans. To the extent that the argument rests on the theory that the salesman's share of the first 12 or 13 installments is sufficient to provide him with the incentive to continue to encourage the purchaser to make periodic payments, it is also subject to question. However true this theory may be as to larger-denomination plans during the period of the early installments, it is clear that it cannot apply to plans of any denomination beyond the first 12 or 13 installments, and for plans of smaller denominations it is doubtful whether the salesman's share of commissions is sufficient to provide incentive for any followup after the original sale. The salesman's incentive to provide followup service is further eroded by the industry pattern of encouraging prepayment of installments subject to the full sales load, which provides no appreciable advantage to the plan purchaser over using the amount of his prepayment to purchase a number of shares at a level load, but which accelerates the salesman's commission.

The performance record of the February 1959 plan purchasers surveyed by the study indicates that a large number of contractual planholders are paying heavily, by comparison with the amounts they have invested, to finance the general distribution of the plans. Given the relative lack of sophistication of the contractual plan purchaser and the incentive to aggressive salesmanship which the front-end load provides, the protection of these purchasers becomes a matter of concern.

8. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

The extraordinary growth of the mutual fund industry in the 23 years since the adoption of the Investment Company Act has raised a group of problems seemingly not contemplated by its framers. The very structure of the industry, unique as it is in the securities industy, creates special problems of concern for the adequate protection of investors. Mutual fund shares, alone among securities offered to the public, are constantly redeemable and continuously offered by their issuers. Their statutorily required redeemability has been taken by most funds and their sponsors to justify if not require the creation of retail sales forces to facilitate the constant offering of shares. The growth of these sales forces is further stimulated by the frequently close relationship of the principal underwriters of mutual funds to their investment advisers, whose compensation is

[238] These devices have been used by Investors' Diversified Services, Inc., W. & R., and Broad Street Sales Corp., among others.

geared to the total net asset value of the fund and is increased as sales increase the size of the funds. Since generally the entire burden of the selling cost of mutual funds is borne by the purchasers of new shares (unlike the usual corporate offering at the market in which the issuer itself absorbs the cost of offering new shares), the funds' sales organizations are not restrained in their selling operations by considerations of costs to the funds. The sales organizations are also protected by the "fair trade" aspects of the Investment Company Act, the NASD rules and the private sales agreements of the underwriters governing the prices and spreads at which shares can be sold.

Mutual funds and contractual plans are sold to investors by securities salesmen employed by a wide variety of firms, including firms engaged in the general securities business such as stock exchange member firms. The standards of selection, training and supervision of salesmen for such firms have been described in chapters II and III, where it is noted that in some cases the requirements for salesmen restricted to sales of mutual funds are lower than those for general securities salesmen. Sales of no-load funds are handled without the use of such sales organizations as are described below. However, a substantial proportion of all mutual fund shares and a very large proportion of contractual plans are sold by salesmen of large or medium-sized firms specializing in the sale of mutual funds, some of the largest of which are affiliated with particular funds, their investment advisers and principal underwriters, and a few of which are not members of the NASD or other self-regulatory organizations. The report's description in this chapter of selling organizations, selling practices and training and supervision of salesmen applies principally, although with significant exceptions, to the sales organizations specializing in mutual fund shares.

The large and medium-sized retail sales organizations which have grown up in the mutual fund industry are characterized by a particularly high turnover of salesmen. The heavy turnover requires them to engage in a continuous program of extensive recruiting, and recruits are overwhelmingly persons totally inexperienced in the securities business. Most sales organizations in fact prefer inexperienced recruits, though they look with favor on sales experience in other fields. The emphasis on inexperienced recruits in turn requires the sales organizations to supply them with such training as will be sufficient to enable them to pass qualifying examinations, where applicable, and to impart to them the tested techniques of mutual fund selling. Sales trainees are almost never paid during their training period, and their training is generally brief and conducted in the evenings on a part-time basis, sometimes in formal classroom-type programs but more often in informal discussions with a sales supervisor. The limited curriculum consists of two parts. The first part primarily provides such rudimentary introduction to the securities business, the Federal and State securities laws, the rules of the NASD and the Federal tax laws as will enable the trainee to pass the NASD examination (except for the large nonmember organizations) and such State examinations as may be required. The balance of training aims largely at acquainting the recruit with the product he will sell and instilling in him effective methods of prospecting, making presentations and closing.

The mutual fund salesman thus briefly trained is then sent out to the public to sell mutual fund shares and contractual plans. He sells almost exclusively on a straight-commission compensation arrangement, rarely with a draw against commissions, and often with the commission schedule weighted to favor sales of the shares of the fund or funds sponsored by his employer. His first sales, apart from those made to himself, are generally made to prospects from his personal circle of acquaintances. To be successful, however, the fund salesman must constantly enlarge his circle of prospects. This enlargement is accomplished through various standard prospecting techniques: Requests for referrals of names from persons to whom he has made sales, "radiation," mailings, telephone calls and the "cold-turkey" call.

In his prospecting and presentations the mutual fund salesman is generally approaching a person who has not previously evinced an interest in buying mutual funds, and he often does not reveal at the outset that he is selling them. He frequently represents himself as an expert in financial planning, but the extent of financial planning performed by most fund salesmen is largely limited to persuading a prospect to invest a portion of his assets or earnings in equity investments. In many organizations the sales presentation is expected to be highly emotional and dramatic in tone, playing on such factors as fear, pride and patriotism. As one industry representative has said of the mutual fund salesman:

> He must do the approaching. Nor can he succeed in the effort of claiming attention with cold recitations of facts, figures and legalistic jargon. He must be imaginative. He must color his approaches with excitement and drama. He must reach human emotions. No laws or regulations will change human nature.

A survey of mutual fund investors prepared for the study by the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania (the Mutual Fund Investor Survey) describes the "typical" mutual fund and contractual plan purchaser, while noting the variations that lie behind the overall view, as a man in his middle-to-late forties, married, with three dependents, a high-school education, a job paying an annual income of $5,000 to $10,000, and life insurance of $10,000 to $15,000. However, the survey also notes a general tendency of the proportion of contractual plan buyers to rise as levels of education, income and occupational skills decline. Among contractual plan purchasers in the lower income brackets, the survey notes that a high proportion are heads of families in low-paying jobs, with a high ratio of their contractual plan commitment to their annual income. It reports, too, that among contractual planholders redeeming their accounts, there is a substantial proportion of planholders in low-income brackets. There is clear evidence of the use of many contractual planholders of their plans as a source of "rainy day" savings and of the purchase of plans by persons with few or no other financial reserves. While emphasizing the lack of comparable data for other types of investors, the survey notes the low level of knowledge of mutual fund investors regarding their funds. The survey comments on the important influence of salesmen in the investment decisions of purchasers, particularly among contractual planholders in the lowest income group.

In relation to the sales presentations made by salesmen, the survey states that in a majority of cases sales representatives were reported to have made no inquiries about the income, financial assets and financial obligations of the purchaser, that 20 percent of regular account purchasers and 10 percent of contractual plan purchasers said they had received no prospectuses, and that many purchasers reported being told that shares were like savings accounts and that fund management and investment policies were supervised or controlled by the Federal Government. While most purchasers reported that sales charges had been explained to them, relatively few could make a reasonable estimate of what they were. Although the first-year sales charges on contractual plans are widely sold as an advantageous penalty which will stimulate saving, only about 40 percent of plan purchasers could reasonably estimate this charge, and a quarter of those redeeming plans who were aware of the impact of the front-end load said that they had not anticipated the impact when they made their purchase. As to future expectations conveyed by salesmen, the survey reports that a majority of fund salesmen exercised restraint in their discussion of prospective changes in fund share market values, but a significant number emphasized a strong chance or near certainty of price increases. In the light of a number of indications of lack of sophistication on the part of mutual fund investors, the survey suggests the need for additional safeguards for their protection.

The principal sales abuse with respect to which investors need protection is high-pressure selling, which may involve salesmen making misleading representations to customers and may lead to the sale of shares or plans to persons for whom their purchase is unsuitable or to switching shareholders from one fund to another for the sake of commissions. To some extent the industry is reluctant to concede that questions of suitability can ever arise in the sale of funds or plans, but both the Mutual Fund Investor Survey and the study's own evidence concerning contractual plan redemptions and lapses leave no doubt that a substantial number of plans are sold to persons for whom, because they have insufficient income or inadequate other financial resources, they are likely to be unsuitable investments. The industry itself recognizes the importance of one's having life insurance and adequate financial reserves for emergencies before making equity investments.

Since mutual fund salesmen generally sell away from their own offices and in the offices and homes of their customers, and since they are generally selling to new customers rather than engaging in continuing transactions for an existing clientele, their supervision presents problems sharply different from the problems of supervising general securities salesmen. The selling activities of most mutual fund salesmen appear to be largely unsupervised. The selling organizations do have hierarchies of supervisory personnel, but the primary activity of the supervisors is selling, stimulating sales and recruiting, and the control which they exercise over the sales tactics of their salesmen is limited. Home office administrative controls, exercised through a review of sales applications at a distance from the point of sale without substantial information concerning the customer's financial status, can at best apply only to the most obvious types of abuse. Only a few companies have established staffs of

roving field investigators to check on salesmen, and these staffs are small in size. For a number of dealers who are members of the Association of Mutual Fund Plan Sponsors, Inc., an industry trade organization, it is evident that in the sale of contractual plans they view the principal control over sales abuses to be the 30-day refund privilege for new purchasers which members of that association offer. However, the number of persons to whom the offer is made who nevertheless pay no installments after their initial payment and who redeem their plans or lapse in payments in the plans' early stages suggests that the 30-day option may be only moderately effective.

Federal controls over mutual fund sales practices include the general antifraud provisions of the securities laws, the disclosure requirements of the securities laws, and the Commission's Statement of Policy covering mutual fund sales literature. While its powers are sufficient to require appropriate sales restraint in the use of the written word, the Commission is presented with difficult enforcement problems in the characteristic home selling of mutual funds through oral presentations. In addition, the Commission's regular inspection programs are difficult to gear to detection of the type of abuse which may most characteristically occur in the sale of mutual funds.

The NASD is the only industry self-regulatory body which significantly controls the mutual fund retail sales organizations, although a few of the largest of those organizations which are wholly integrated are not members of that association. The Commission looks largely to the NASD for enforcement of the Statement of Policy, and the NASD has brought a number of disciplinary actions relating to its violation, as well as for charges of switching funds and "selling dividends." For the NASD too, however, the home sale of funds makes detection of high-pressure sales a difficult problem.

The sale of contractual plans poses a special problem. These plans are basically long-range programs for investing in the shares of a particular mutual fund on an installment basis but with the unique feature that the purchaser is required to pay a substantial portion of the total sales charge in advance (the "front end load"). As a consequence of this front-end load a purchaser in essence commits himself to purchase shares of a particular mutual fund over a period of time—typically 10 years—on the basis of information concerning the fund supplied to him at the time he makes his first purchase. If adverse personal circumstances render the purchaser financially unable to continue his purchases, if his investment objective changes, if the fund no longer enjoys his confidence, or if for any other reason he no longer wishes to invest in the fund, he discontinues his purchases only at the cost of a penalty. In this respect contractual plans, which contemplate a commitment to purchase securities far in the future on the basis of information received in the present, are an exception to and appear somewhat inconsistent with the underlying philosophy of the securities laws that an investor shall have current information available to him at the time of purchasing securities on which to base his investment decision.

The security which the contractual plan purchaser acquires is much more complex than that acquired by the direct purchase of mutual fund shares. The prospectus which describes what the contractual plan purchaser has bought (and what it costs him) is typically longer and more difficult to understand than the prospec-

tus which is delivered to the direct purchaser of mutual fund shares. Paradoxically, a substantial number of these complex securities are sold to the least sophisticated portion of the investing public. A high proportion of contractual plan purchasers are making their first purchase of equity securities. Many of them are persons in low-income brackets with heavy family responsibilities and no financial resources apart from their wages or salaries. A large proportion of these persons do not understand the amount or the impact of the front-end load. They are, for the most part, unaware that mutual fund shares may be acquired in a less expensive way through a voluntary or level-load plan or through no-load plans.

The sale of complex securities to unsophisticated investors in a way which permits the investor fully to understand and evaluate the intricate merchandise he is acquiring is at best a difficult task. High-pressure selling, inadequate training of and lack of adequate supervision and control over salesmen, all of which appear to be present to a high degree in the sale of contractual plans, make its accomplishment most unlikely. The front-end load structure encourages high-pressure selling. The substantial commission which a salesman receives from the initial 13 payments, particularly when the purchaser prepays a number of them as he is usually urged to do, gives the salesman a strong incentive to sell these plans regardless of the circumstances of the purchaser in order to realize commissions on at least the front-end portion of the load.

The Special Study statistics on persons purchasing plans in February 1959 demonstrate the heavy cost which many contractual plan purchasers have paid in order to invest in equity securities. After 3½ years, one-sixth of all contractual plan purchasers, by virtue of redemptions and lapses in payment, had paid an effective sales load of 50 percent of the amount paid in (or 100 percent of the amount invested for them in fund shares). An additional one-sixth of these purchasers had redeemed or lapsed having paid an effective sales load in excess of 18 percent. Thus, about one-third of all such purchasers had paid an effective sales load of from two to five times the 9-percent maximum overall charge for completed contractual plans permitted under the Investment Company Act.

The contractual plan industry justifies this front-end load on three principal grounds: few people lose money while in the long run most people make money; the "penalty" of the front-end load is necessary to stimulate most people to regular savings habits; and the advance payment is necessary adequately to compensate salesmen for bringing the benefits of equity investments to persons of modest means. None of these justifications is persuasive.

In recent years roughly 15 percent of contractual plan purchasers have redeemed with losses within 5 years of purchase of their plans. This is a substantial number, particularly in light of the recent history of generally rising markets. Further, as indicated above, an even more substantial number of purchasers have paid an extremely high sales cost for their investments. Even in the absence of these points, the industry's first argument is not persuasive because it ignores the fundamental question of the relationship of sales charges to the amounts invested, and instead—unique in the securities industry—attempts to justify a sales charge on the basis of the ultimate success of investors taken in the aggregate.

The extent to which the penalty feature of the front-end load actually serves to encourage regular investing habits is also open to question. The Special Study figures on February 1959 plan purchasers also show that 3½ years later, more than one-third had not persisted as regular savers, while the balance included a number who might be called occasional investors. Even for the regular investors it should be noted that stimulants other than the front-end load penalty, such as mailed reminders and the concomitant purchase of completion insurance—both available in some voluntary plans as well as in contractual plans—have played their part in developing savings habits. The front-end load itself provides no inducement for salesmen to encourage savings habits, except during the first year when high commissions are deducted from plan payments. Thereafter, the load will be less than that of a voluntary plan, and it would seem to follow that the salesmen's inducement to encourage savings over the life of the plan would be less than in a voluntary plan. Furthermore the inducement which salesmen have in the first year to encourage customers' saving is subverted by the practice of obtaining prepaid installments subject to the front-end load.

In the sale of contractual plans the actual investment performances of contractual plan purchasers are generally ignored or occasionally misstated. In the past they have not been required to be disclosed in the prospectus, and salesmen have been free to point to tables showing the past growth of an investment in the plan they are selling, based on the ideal assumption of a perfect investment record, without noting that a substantial majority of plan purchasers come nowhere near achieving such a record of payments. Salesmen of many funds are encouraged to tell purchasers that 9 out of 10 contractual planholders complete their plans, with the implication that they complete them according to schedule. The actual rates of redemption and lapse in payment by planholders are not disclosed.

The argument that the front-end load is necessary to finance the sale of mutual fund shares to the public is overstated. Clearly, mutual funds can be, and are, sold without a front-end load. Indeed, California, the State which in 1962 led all others in mutual fund sales, prohibits the sale of contractual plans. A byproduct, of questionable value, of the front-end load is that the newcomers who are attracted into contractual plan selling generally make their initial, and often sole, sales to their relatives and intimate friends. Clearly the soundness of such sales may often be questioned.

The study's analysis of the problems related to the sale of contractual plans should not be misconstrued as criticism of the value of the underlying securities, as to which the study takes no position. Nor should the study's analysis be taken by any planholder as a reason for redeeming any plan certificates. Early redemptions of plans, as has been noted, almost inevitably result in losses to the planholders, and the questions raised by the study, being unrelated to the merits of the investments themselves, should not result in investors' incurring losses on investments already made. They are addressed, on the contrary, to the issue of whether (or the conditions under which) contractual plans should be permitted to be sold in the future.

In view of the Commission's continuing comprehensive program of study of fundamental structural problems of the investment company

industry, it would be premature for the Special Study to promulgate definitive recommendations on the isolated segment of the contractual plans. It is not inappropriate to note, however, the conclusion of the Special Study that the combined factors of the incentive to high-pressure selling which the front-end load provides to salesmen, the essentially unsupervised nature of home selling of plans, the complexity of the security sold and the lack of financial sophistication of so many of the purchasers of plans create a problem of a fundamental nature which cannot be solved through the mere application of the doctrines of disclosure.

It is the front-end load structure itself and the economic incentives which it gives to salesmen which are responsible for the failure of the disclosure concept adequately to protect the public from untoward selling pressures in contractual plan sales. Under these circumstances only compelling reasons can justify the continued existence of the front-end load. The study has concluded that the justifications advanced by the industry are hardly persuasive and certainly not compelling. Therefore serious consideration should be given to the elimination of future front-end load plans.

Should it be concluded in connection with the pending broad study of investment company structural problems that prohibition of future front-end loads is not called for, at a minimum their permissible limits should be fundamentally altered. The maximum amount deductible for sales charges from early installments should be lowered, the installments from which they are deducted should be spread out, and the deduction of sales charges from prepayments should be prohibited in an amount in excess of the deductions from the later installments under the plan.

The principal industry justification for the existence of a front-end load is that some persons need the stimulus to savings which prepaid sales charges provide. If persons wishing to subject themselves to a penalty provision for the discipline which they believe it will give them are to be permitted to do so, they should do so consciously and voluntarily, with an awareness of the alternative forms of mutual fund investment. At present, a high percentage of investors in contractual plans are unaware of the existence of accumulation plans which do not involve a front-end load, some of them with completion insurance and some with low initial and continuing payments. They should not subject themselves to the front-end load unwittingly or for lack of a clear alternative. If the front-end load is not to be prohibited, any fundamental alteration of its structure should be combined with a requirement that any mutual fund sales organization offering a front-end load contractual plan to any person simultaneously offer such person the opportunity to purchase shares of the same underlying fund under a level-load voluntary plan, but otherwise on substantially the same terms. Such a provision would not, of course, compel any contractual plan sponsor to offer voluntary plans on an uneconomic basis. It would, however, preclude the offering of contractual plans except on a basis reasonably calculated to insure that the purchaser of a contractual plan had made a conscious election to impose a penalty upon himself in the event of his failure to make the required payments.

The Special Study concludes and recommends:

1. The study was not concerned with and has not attempted to evaluate the merits of mutual fund shares as an investment medium, and nothing contained in this report should be construed as an endorsement or criticism of investment company shares generally or of those of any particular company, or as a basis for purchasing or redeeming any such shares. However, certain factors peculiar to the mutual fund industry create pressures toward undesirable selling practices. Evidence suggests the existence of such practices to an unfortunate degree. Industry representatives and the NASD, in consultation with the Commission, should jointly undertake a program designed to eliminate such tactics and devices through the adoption of interpretations of the Rules of Fair Practice. The further development of secondary supervisory controls by industry members is desirable, and the NASD should increase its activities in the surveillance of selling practices outside of the area of advertising and sales literature. As recommended in chapter II, membership in the NASD or another registered securities association should be required of all mutual fund selling organizations, and any such association should be required to maintain standards equivalent to those adopted by the NASD in accordance with this recommendation. Reference is also made to the recommendations in chapter II concerning the qualification and registration of salesmen.

2. Prospectus requirements should be further refined to assure that basic information is brought clearly and conspicuously to the attention of the prospective investor. The Commission should require a summary on the cover, or as prominently as possible at the beginning of each prospectus, of the sales charges, expense ratios, advisory fees, performance objectives, and other basic information, and should require disclosure of any special or extra compensation arrangements for the sale of particular funds by mutual fund salesmen or of the fact that the salesman can only offer a particular fund or funds. It should amend the Statement of Policy to require that tables which are used to reflect results of plan completions also indicate performance records of plan investors. It should also consider an exercise of its rulemaking power to define deceptive practices in connection with recommendations of switches from one mutual fund to another.

3. In conjunction with its comprehensive program of study of the investment company industry, the Commission should recommend to the Congress legislation amending the present provisions of the Investment Company Act of 1940 which relate to contractual plans. Consideration should be given to the abolition of any future front-end load. If it should be concluded that such abolition is not called for, such legislation should both substantially limit the amount and method of application of any such load and prohibit the offering of front-end-load contractual plans by any mutual fund sales organization without the simultaneous offering of a level-load voluntary plan for shares of the same fund and (except for prepayment of selling charges) on substantially the same basis.

C. Reciprocal Business—The Problems of Allocating Mutual Fund Portfolio Brokerage

1. THE SPECIAL NATURE OF RECIPROCITY IN THE MUTUAL FUND INDUSTRY

An estimated $6 billion of equity securities were bought and sold by mutual funds in 1961. The allocation of brokerage commission on this vast amount of valuable brokerage business, probably aggregating about $60 million in 1961, is largely determined by a pattern of practices which have come to be known as "reciprocity" or "reciprocal business." With the growth of the mutual fund industry these practices have become more intricate, and it is appropriate to review the manner in which they operate, their impact on the relationship of mutual funds to the organizations which sell fund shares, and some of the problems which they raise.

The NASD has stated:

> Stripped of its complexities, "reciprocity" means doing business with people who do business with you. The definition applies to business in general, the securities business as a whole, and in the investment company segment of the securities business.

This description contains an appropriate reminder that reciprocity is common to all types of business. It is per se neither unethical nor illegal. But to strip reciprocity of its complexities in the investment company area, as the NASD statement suggests, is to divorce it from any semblance of reality. The complexities of the interrelationships of the mutual funds, their investment advisers, their principal underwriters and broker-dealers, and of the interaction of fund portfolio transactions and exchange minimum commission rate schedules, have given rise to certain unique features and problems of conflicting interests special to reciprocity in mutual funds.

That these reciprocal business practices raise problems has been recognized before, both outside of and within this report. The 1962 Study of Mutual Funds prepared for the Commission by the Wharton School of Finance & Commerce (the Wharton School Report), in a section on "Brokerage Allocations to Dealers in Open-End Company Shares and to Others,"[239] contains various quantitative analyses of reciprocity, and no attempt has been made by the Special Study to make its own quantitative determinations in the area, although occasional reference will be made to findings of the Wharton School Report. Certain aspects of reciprocal business have already been described in chapters VI.I relating to the NYSE commission rate structure, VIII.C relating to block transactions, VIII.D relating to over-the-counter trading in listed securities, and VIII.E relating to regional exchanges; and part A of this chapter has noted its relationship to the structural elements creating pressures for sales of fund shares.

What principally distinguishes reciprocity in the investment company area from other areas is the identity of its beneficiaries. The ordinary case of reciprocity in the securities business involves an exchange between two firms, each of which benefits from the services rendered by the other. An NYSE member, for example, reciprocates for exchange commission business given it by a nonmember

[239] "A Study of Mutual Funds," H. Rept. 2274, 87th Cong., 2d sess., pp. 525–539.

firm by returning regional or over-the-counter business to the non-member.[240] In the mutual fund field, however, fund portfolio brokerage business is allocated on the basis of services rendered by brokerage firms which may directly benefit the fund's investment adviser and principal underwriter but which benefit the fund itself only indirectly, if at all. The most common basis for allocating fund portfolio business is to reward broker-dealers for the sale of fund shares. Those who benefit most from the sale of new fund shares are the fund's investment adviser, which is generally compensated on the basis of a percentage of the aggregate net asset value of the fund portfolio, and its principal underwriter, which is compensated through the markup or "load" on each new share sold. On the other hand, the fund itself derives no income from sales of its shares, nor does it participate in the profits of its investment adviser or principal underwriter. Fund shareholders therefore receive only such indirect or intangible benefits as may result from a continuous offering of the fund shares or from owning shares in a fund with more shareholders and assets.

As has already been suggested,[241] a major reason for the failure of mutual funds to benefit directly from the allocation of their portfolio brokerage business is the New York Stock Exchange's minimum commission rate schedule and antirebate rules.[242] A substantial portion of the portfolio transactions of most funds is in equity securities listed on the NYSE and takes place through NYSE members. Since the minimum commission rate schedule makes no provision for block discounts or similar advantages to those engaging in large transactions, the commissions generated by most mutual fund transactions on the Exchange are sufficiently large to permit the broker-dealers which handle them to do so profitably even after paying out 60 percent (the ratio customarily used) of the total commissions to other broker-dealers. It would of course be highly advantageous for the shareholders of the funds if the fund portfolio transactions could be handled at only 40 percent of their present cost, but the provisions of the NYSE constitution relating to commissions and service charges prohibit the reduction of commission charges to the funds and forbid the return of any part of the commission to them. It thus lies within the power of the funds (or their investment advisers or underwriters) to direct payment of a substantial portion of the funds' commission costs, but not directly to the funds themselves.

The problems of the minimum commission rate structure and its regulation are dealt with elsewhere in this report[243] and will not be the subject of additional comment here. However it is appropriate to note that, so long as the present structure exists, there is no impropriety in directing the benefits of reciprocity to beneficiaries other than the funds, if the acquisition or use of these benefits does not in any way operate as a detriment to the funds and if the funds have themselves derived as much as they can from these benefits. As will be discussed later, the problems are quite different in connection with portfolio transactions which can and do take place in the over-the-counter market, where no minimum commission structure exists.

---

[240] See the discussion of reciprocal business arrangements at ch. VI.I.2.a(1).
[241] See pt. A.1, above.
[242] NYSE constitution, art. XV.
[243] See ch. VI.I.

2. FACTORS DETERMINING THE ALLOCATION OF PORTFOLIO BROKERAGE BUSINESS

The allocation of mutual fund portfolio brokerage is affected by a number of variables. Among them are the structure and size of the mutual fund sales organization and relationships between it, the fund, the principal underwriter and the investment adviser; the services rendered by various broker-dealers; the choice of markets available for execution of transactions in a given portfolio security; the membership or nonmembership of retail broker-dealers in the NYSE and other exchanges; and the differences among broker-dealers in their ability to execute various types of securities transactions. From the point of view of the shareholder brokerage should be allocated so that, first, each portfolio transaction is executed in the market offering the best terms for that transaction (i.e., the most favorable combination of price and brokerage cost); and, second, that any "excess" brokerage commission incurred on necessary stock exchange business is used to purchase services which directly benefit the fund. Typical fund prospectuses, however, appear to emphasize only the first consideration, even when disclosing other factors which motivate their choice of brokers:

> 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.

The determination of the allocation of portfolio brokerage basically ought to be a decision of the fund itself, as the entity whose transactions produce the brokerage. In fact, brokerage is generally allocated by the fund's adviser and/or underwriter, though practices vary considerably among funds with respect to the details of allocation. Of the funds replying to the study's institutional investor questionnaire (IN-4), some maintained their own trading departments which determined allocations to brokers, while for others the function was performed by their investment advisers or management companies. In some cases the role of the principal underwriter in allocating brokerage is provided for under its contractual arrangement 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. * * *

For practical purposes, however, such contractual provisions may be unnecessary in the light of the close relationship of most funds with their underwriters and advisers. One group of funds has designated a committee of five officers to select the brokers through whom purchases and sales of portfolio securities are to be made and to designate the brokers to participate in the commissions thereby generated. Each of the five is also an officer of the principal underwriter of the group of funds.

a. Services for which portfolio brokerage is allocated

(1) *The sale of fund shares*

The practice of allocating brokerage business and commissions in the mutual fund industry according to services rendered by brokers

is, according to testimony at the Special Study's public hearings of an officer of one principal underwriter, "universal." The statement is borne out by information available to the study, as well as by the findings of the Wharton School Report.[244] It is further apparent that the major service compensated by brokerage allocations is the sale of shares of the allocating fund. The Wharton School Report notes:

> Sales of investment company shares were not only most frequently referred to as a factor influencing brokerage allocations, they were commonly referred to in these replies as the principal factor influencing such allocations.[245]

For funds whose shares are sold through a substantial number of broker-dealers, the apportionment of brokerage among these brokers may call for systematized procedures to accomplish the dual objectives of equitable distribution and expert execution. The manner in which these procedures can operate is illustrated through the organization of Hugh W. Long & Co. (Long), the principal underwriter of three mutual funds with aggregate net asset values at the end of 1962 of over $850 million.[246] As underwriter for the 3 funds, Long has selling agreements with a network of 2,500 broker-dealer firms which make the retail distribution of the funds' shares. The investment of the proceeds of sale of new shares and changes in the funds' existing portfolio generate a substantial amount of portfolio brokerage business to be allocated.

According to one Long executive, substantially all of the brokerage of the funds which it underwrites is directly or indirectly allocated to firms which do a substantial volume of business in the shares of such funds, except for some business allocated to "service rendering organizations." The selection of the recipients is made on the basis of periodic examinations by Long personnel of the recent sales of fund shares in each of the organization's regions as compared with national sales figures. After determining the proportion of brokerage business to which each region is entitled, Long officials consider suggestions from wholesale representatives in each area and make detailed scheduled allocations of brokerage to particular broker-dealers. Since the total number of firms involved runs into hundreds, however, Long does not directly execute transactions through all of them. As a fund officer explained:

> We prefer that discussions of orders for the funds be done with a limited number of brokers in order to insure that the funds are regarded as principal clients of these brokerage firms—which aids in the getting of the best executions. These brokers we call primary brokers.

The primary brokers, which vary from year to year, numbered 12 in 1962, and included 4 large wirehouses with many branch offices through which considerable sales of fund shares were made, 1 firm providing direct wire facilities to the Long offices, 1 firm providing bond quotations, 1 firm providing twice-a-day stock price quotations on which the funds' sale prices were based, 3 firms which handle block transactions, and 2 firms which were members of the Midwest and Pacific Stock Exchanges.

---

[244] P. 527.
[245] Ibid.
[246] Fundamental Investors, Inc. (net asset value, $643 million); Diversified Investment Fund, Inc. (net asset value, $101 million); and Diversified Growth Stock Fund, Inc. (net asset value, $110 million).

The large number of brokers who are not primary brokers are compensated for the services they have rendered in selling shares of Long-sponsored funds through a method known as "give-ups." The operation of give-ups was explained by a Long officer in the study's public hearings in the following testimony:

A. * * * The primary brokers all agree in advance of our arranging with them to do business with them, that they will give up, according to the rules of the exchanges of which they are members, a maximum portion of each dollar of commission business that they receive to other broker-dealers who are members of the same exchange or exchanges. Specifically, if a member of the New York Stock Exchange receives $100 in commissions for executing some orders, and this is a primary broker for us, he will understand that he will give away $60 out of the $100 to other members of that exchange.

Q. Are the payments of those $60 generally referred to as give-ups?

A. Those are called give-ups; yes.

Q. When these give-ups are made, are they made to other broker-dealers who are members of the exchange on the basis of sales by those broker-dealers of mutual fund shares?

A. Substantially so. I would like to indicate what I mean by my exceptions * * *. There are some firms which are members of the exchange on which a transaction has been made who receive give-up commissions courtesy of certain nonmember firms * * *. There are three member firms, as you know, which print various materials useful to mutual fund salesmen.[247] The salesmen of broker-dealers who are not members of an exchange can effect payment for the material purchased from these member firms by asking us to route give-up commissions or direct executions also to the member firms that produced the literature.

* * * * * * *

Q. Is it a fair summary to say that in the case of sales by New York Stock Exchange members who are not directly handling commission business for you, they receive give-ups in the form of a check without rendering services in connection with the brokerage business itself?

A. That is right.

Q. In effect this is compensation to them for the selling services in addition to the compensation they receive as part of the selling charge, is it not?

A. This is correct. We state in our prospectus that brokers who sell shares may receive some commissions.

Q. This, I understand, would be a rather desirable thing on the part of a New York Stock Exchange member to receive additional compensation without performing additional services, would it not?

A. It turns out to be precisely that. But as I have indicated, it is a matter of great convenience for those who have to administer the funds not to request of several hundred member firms that they carry on executions for the funds.

While mutual funds, including the Long group, state that the allocation of portfolio brokerage in exchange for selling services is not done on the basis of an automatic formula, it is clear that a substantial portion of give-up commissions at least are apportioned on such a basis. The Wharton School Report notes:

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 percent of the gross amount of its shares sold by various broker-dealers over a period of years.[248]

Responses to the Special Study's institutional investor questionnaire (IN-4) show the continued existence of a reciprocity ratio of $1 of brokerage business or the equivalent in give-up commissions for each $1 of mutual fund share sales, but also indicate that a 2-to-1 ratio is

---

[247] In fact there are five such firms; see sec. (2) (a), below.
[248] Wharton School Report, p. 534.

sometimes used.[249] In some situations higher ratios result from special efforts to stimulate certain dealers' sales, on occasion reaching 5 to 1 or higher.

Reciprocal ratios do not get written into sales agreements with principal underwriters, but 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 result 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 * * *.

He further conceded that in some instances the company could not compete with other funds or distributors if it did not provide give-ups.

The competitive impact of reciprocity for selling efforts can also be seen from another perspective in the case of one fund underwriter which, as an NYSE member firm itself, transacts most of the portfolio business for its fund. The Dreyfus Fund employs the affiliated firm of Dreyfus & Co. as its usual broker, and states that no brokerage business is directed to any firm on the basis of sales of fund shares. However underwriter Dreyfus & Co. retains only 0.5 percent of the 7.5 percent sales charge on Dreyfus Fund shares, leaving 7 percent available for the retail broker-dealer rather than the more customary 6 percent—thus overcoming the competitive handicap of failing to reciprocate for sales.

(2) *Other services*

While the allocation of fund portfolio brokerage on the basis of services rendered in the sale of fund shares appears to predominate, allocation on the basis of other services rendered by broker-dealers also occurs to a significant extent. Apart from the sale of fund shares, the Wharton School Report specifically lists as services which become the basis of allocation of fund brokerage business: the provision of investment research and statistical information; daily quotation services for portfolio evaluation; provision of direct telephone lines and wire services; and provision of sales promotion material, sales advice and aids; and receipt of publications.[250] If reciprocal business were not available to pay for many of these services, fund advisers or underwriters would have to pay for them.

Reciprocal brokerage is allocated for services other than sales of shares by all types of fund organizations. As noted above, three of the primary brokers of the Long organization provided such services as direct wire services and quotations. In addition, funds which do not rely on independent broker-dealers for sales of fund shares allo-

---

[249] See the discussion in ch. VIII.C.4.c of reciprocal business practices of institutional investors, in which the statements of certain mutual funds concerning their use of ratios are quoted.

[250] Wharton School Report, p. 527. Other factors affecting allocation of fund brokerage listed by the Wharton School Report, aside from sales of fund shares and the services noted above, are: "Ability to execute sales efficiently and at best price"; "Affiliations"; "Location"; and "Other services."

cate brokerage on the basis of services rendered to their sales organizations. One such organization is Investors Diversified Services (IDS), which sells shares of its affiliated funds solely through its own sales organization. As to the allocation of fund portfolio business, a recent prospectus of one of the funds it services states that its orders are placed through one NYSE member firm, Scheffmeyer, Werle & Co., which in turn distributes them among 45 to 55 other member firms as directed by the fund's investment manager. The allocation is made—

* * * in a manner which seeks to give recognition to those member firms which are capable of rendering services and which, over time, do render services over and above the bare brokerage function although this is not an absolute standard since some business may be distributed solely on the basis of the best judgment of the investment adviser. * * * Such services may be in terms of expeditious handling of orders, contributions made by such firms' research staffs in supplementing, aiding, or otherwise helping the research activities of the investment manager, referrals of direct placements, wire services, quotations, statistical and economic data and reports, and other related services which large brokerage houses can and do render to important buyers and sellers of securities without extra charge. * * *

One of the more unusual services rendered by a broker-dealer to IDS and paid for in portfolio commission business is that rendered by Scheffmeyer, Werle & Co. itself. As stated by IDS:

Scheffmeyer splits up the daily orders and parcels them out among the group of brokers (not including Sheffmeyer) designated periodically by IDS. Scheffmeyer has agreements with all such brokers, under stock exchange rules, whereby a certain portion of the aggregate commissions received by such brokers on IDS Group business is paid monthly to Scheffmeyer. Out of the aggregate amount of such payments, Scheffmeyer deducts a fee for its services (currently $15,000 per month plus $2,000 monthly for the cost of the direct wire to IDS), and redistributes the balance of such payments to the participating brokers so that their share of the net commissions on the aggregate orders of the IDS Group will approximate the percentage of the total of such commissions which has previously been designated by IDS.

As of April 1962 there were five NYSE member firms [251] engaged in providing the services relating to sales promotion referred to in the Wharton School Report for which payment was to be made in commission business from mutual fund portfolios. The materials and services which these firms distribute cover a wide range. Some of them are books and charts containing information on the characteristics and performance records of mutual funds of a statistical or investment advisory nature. Others of a more clearly sales promotional nature are listed in a memorandum prepared by the Department of Member Firms of the New York Stock Exchange:

(1) Monthly advertising copy ready for insertion in newspapers and sales letters for direct mail prospecting.
(2) Individual consulting service for design of direct mail promotion, advertising, radio scripts, and other sales campaigns.
(3) Sales technique training programs, written, on records, and on film.
(4) Point-of-sale flip chart kits, strip films and records for use of salesmen.
(5) Mutual fund promotional strip film presentations (prepared by professionals and purchased by a member at $150 per kit.)
(6) Sales training programs to prepare salesmen for the NASD examination.
(7) Monthly posters designed to motivate salesmen.
(8) "Statistics" on pension funds prepared by an outside agency and offered as "prospect list" to nonmembers.

---

[251] The firms were: Hugh Johnson & Co., Inc.; Kalb, Voorhis & Co.; Laird, Bissell & Meeds; Lubetkin, Regan & Kennedy; and Arthur Wiesenberger & Co.

(9) Copy for a monthly newsletter for dealer prospects and customers, ready for monthly printing under dealer letterhead.
(10) Weekly rentals on a mutual fund promotional motion picture, with promotional literature.
(11) Promotional booklets on mutual funds.
(12) Sales promotion manuals.
(13) Individual investment record folders for customers of nonmembers, furnished with nonmember imprint.
(14) A monthly magazine for dealer customers.

The nature of much of this sales training and sales promotional material has been indicated in a prior section of this chapter.[252] It is largely designed for the use of mutual fund salesmen and sales trainees, and is available to the organizations which employ them either for cash or for commission business directed to the firm which produces it. For $300, for example, a firm can subscribe to the Modern Securities Service produced by Kalb, Voorhis & Co., a regular service which provides its subscribers with such material as prepared newspaper advertisements, sales and newsletters, a sales training publication with articles on using the telephone in mutual fund selling and using the tax laws to sell fund shares, scripts for sales meetings, a current fund data chart giving monthly asset values and dividend and capital gains distribution information, and monthly publications entitled "Financial Planning" and "Mutual Fund Selletter." A Kalb, Voorhis phonograph record album for sales training is available for $400. Its CMFR training course [253] costs $40 in cash or $80 in commissions, with discounts for volume purchases. Most items cost two to five times as much in commission business as in cash. Arthur Wiesenberger & Co., for example, charges $25 in cash or $75 in commission business for its publication "Charts and Statistics." It explained the differential in a letter addressed to broker-dealer customers in the following way:

> The reason for these ratios is obvious—*commissions are not the same as cash.* We must *earn* those commissions, performing services identical to those any other firm would have to provide in executing orders—and also must cover our own cash outlay for the material and services supplied [Emphasis in original].

The justification for the differential is more difficult to explain in the case of give-ups. Since a service give-up is actually a check sent by the executing member firm to the member firm providing promotional services, one might expect the give-up to be treated as the equivalent of cash, yet the service firms do not so treat them. Wiesenberger indicates that it will recognize $70 in give-ups as the equivalent of $100 in commission business; i.e., if a book costs $25 in cash or $100 in commissions, Wiesenberger will accept $70 in give-ups as full payment. Somewhat along the same lines, Hugh Johnson charges $35 per copy in cash for *Johnson's Charts*, $40 per copy in give-ups or $75 in commissions. Kalb, Voorhis, on the other hand, indicates that pursuant to NYSE instructions it treats give-ups as the equivalent of commissions and makes no adjustment in favor of give-ups.

Regardless of the ratios, most of the fund-dealer customers pay for the promotional services obtained through these firms by directing

[252] See pt. B.4.b.
[253] See description in pt. B.3.b.

reciprocal commission business or give-ups to them. According to Wiesenberger, less than 5 percent of its gross income from promotional services in 1961 was received in cash, with the balance received in commissions and give-ups, while Kalb, Voorhis stated that its cash receipts amounted to 13.5 percent of total payments for services. Altogether the five firms' sales totaled more than $2 million in 1961. A Kalb, Voorhis partner estimated that "about 40 percent of the [mutual fund] industry uses some of our services."

The most unusual sales promotional service performed in exchange for reciprocal fund business which came to the attention of the Special Study involved a short-lived public relations program sponsored by the Association of Mutual Fund Plan Sponsors, Inc. (AMFPS). In November 1960, the AMFPS established a Public Relations Committee under the chairmanship of William G. Damroth,[254] with a view to promoting the sale of contractual plans. Damroth arranged to have A. G. Becker & Co., an NYSE member firm, finance a publicity campaign which was carried on by Publicity Consultants, Inc., a public relations firm. The terms of the arrangement were outlined in a letter from a Becker partner to the head of the public relations firm:

> (1) A. G. Becker & Co., Inc., wishes to increase its mutual fund business from its present modest size to one of considerably greater proportions.
>
> (2) It does not regard the usual type of sales promotion as ideally suited to accomplish this objective in as short as possible a time. There are too many of our competitors already too strongly entrenched in this field.
>
> (3) Toward this end you will undertake to prepare for us a subtle public relations program to be outlined in a prospectus.
>
> (4) The program will not contemplate our contracting for, hiring or paying for any advertising space, or any radio or TV time.
>
> (5) Your fee will be $3,000 per month for as long as we continue the program. We may terminate this program at any time on 1 month's notice. No disbursements are to be made by you for our account without our express prior approval.

Becker's expenses in connection with the campaign were to be covered by commission business directed to it by the funds with which AMFPS members were associated.

The first tangible result of the publicity campaign was an AMFPS luncheon for the press, held at an expensive New York restaurant, at which four individuals who had completed their contractual plans were honored. Articles written by financial writers who attended the luncheon were published in a number of papers throughout the country, and according to Damroth more than 150 radio and television stations with a potential audience of over 63 million persons broadcast 1- or 2-minute releases on the luncheon prepared and distributed by Publicity Consultants, Inc. In July 1961, Publicity Consultants provided material for an Associated Press story on mutual funds which was carried by over 300 newspapers. The final fruit of the campaign was a magazine article on the merits of purchasing mutual funds through contractual plans, which was intended for publication by the mass-circulation magazine Coronet, but which finally appeared in Esquire when Coronet ceased publication in the summer of 1961. The article was written by a freelance writer on commis-

[254] Damroth is president of Templeton, Damroth Securities Managers, Inc., which is a member of the AMFPS and investment adviser, principal underwriter and contractual plan sponsor of several funds.

sion from Publicity Consultants, which paid him $2,000 and did all necessary rewriting and handled arrangements for its publication. Reprints were distributed to women's clubs, educators, union officials, State security commissioners and editors.

Becker's expenses in connection with the publicity campaign aggregated $27,000 for 9 months' retainer fees for Publicity Consultants and over $10,000 in out-of-pocket expenses. In all it credited to its special public relations account approximately $93,000 in commissions from funds affiliated with the relatively small number of AMFPS members which actively supported the campaign. The campaign was abandoned in the fall of 1961. The limited mutual fund support of the program probably was a factor in its discontinuance, but the intervention of the NYSE undoubtedly was decisive. While a partner of Becker had discussed the program with an officer of the Exchange prior to sponsoring it, the Exchange staff, after a review of the campaign, requested that it be terminated.

The AMFPS public relations program may have contributed to the NYSE's 1962 change in its interpretations relating to dealer promotional services which its members should be permitted to offer nonmember firms in return for commission business. For some years the Exchange had approved as not involving any rebate of commissions the rendering of certain dealer promotion services by members to nonmembers in exchange for reciprocal commission business. Under these NYSE interpretations, such services could be supplied nonmembers under certain conditions: the service had to have been developed by the member firm staff; the name of the member firm had to appear prominently on all printed matter; and the member firm had to recover in cash at least its cost for any materials prepared in substantial part outside the firm, although an additional charge in commissions was permissible. Under this interpretation Kalb, Voorhis, for example, would purchase a filmstrip projector and record-playing combination from an outside company for $75 in cash and in turn make it available to its customers for $75 in cash and $50 in commission business.

Following its disapproval of the AMFPS publicity campaign as a permissible dealer promotion service, the NYSE staff reviewed all such services rendered by its five member firms engaged in supplying the services described earlier in this subsection. The staff concluded:

> * * * it appears to the staff that normal business expenses of nonmembers are being absorbed by members through some features of the dealer promotional services in much the same way that paying the rent of a nonmember would be a payment of business expenses. As such, the offering of such services for commissions may constitute a rebate of commissions in contravention of article XV, section 1 of the constitution.

After considering objections of the five member firms concerned,[255] the Exchange in June 1962, adopted an interpretation restricting the "statistical and investment advisory services" which may be offered by members to nonmembers for commission business to "publications or services intended to aid professional or nonprofessional clients of member firms in investment decisions concerning securities or com-

---

[255] The affected firms generally questioned the logic of the Exchange in singling out "dealer promotional services" for special treatment among all of the extensive services offered by member firms for reciprocal business.

modities." Firms supplying "noncomplying services"—i.e., purely promotional material—for reciprocal commission business are to withdraw such materials on a schedule aimed at eliminating the practice by 1965. The NYSE will not object, however, to firms providing purely sales promotional materials for cash, so long as the cash price covers all costs of creating, producing, and distributing the service, even though the offer of material for cash may be contingent on an additional payment of commission business.[256]

b. The impact of exchange membership

For the broker-dealer firm which has rendered services relating to a mutual fund, whether in selling its shares or in some other way, the manner in which it will be compensated for such services depends in large measure on the exchange or exchanges of which it is a member.

The problem is least complicated for members of the New York Stock Exchange. As has been suggested above, the fund, fund adviser or fund underwriter which wishes to reward a NYSE member for sales or other services can do so either directly by placing with it an order to buy or sell an NYSE-listed security on the Exchange or indirectly by instructing another NYSE member firm with which it has placed an order to give up a portion of its commission on that order to the firm to be rewarded. In the latter case the rewarded firm performs no function in connection with the execution itself. The give-up of a portion of the commission to it does not violate the Exchange's antirebate rules, which apply only to commission splitting with nonmember firms. From the point of view of the fund and its shareholders, the give-up does not involve an additional amount above the Exchange's minimum commission rate schedule, which requires that it pay the same brokerage commission for a transaction executed on the Exchange, regardless of who performs the execution or benefits from the commission.

The growth in recent years of the over-the-counter market in listed securities [257] casts a shadow of conflict on these transactions, however. If a fund makes a purchase on the NYSE of a listed security which is available as well from an over-the-counter firm on better terms, its choice of the Exchange method would be counter to the best interests of the fund and its shareholders, except in unusual situations.

For a broker-dealer which is not a member of the NYSE but is a member of a major regional exchange, the manner of its reciprocal reward is not substantially more complicated, despite the NYSE antirebate rule. The reciprocal allocation of a portion of portfolio fund brokerage to a wider circle of fund retailers is made possible by the existence of the dual trading system, whereby many NYSE-listed securities are also traded on regional exchanges, and the dual membership system, whereby a number of NYSE members also have memberships on regional exchanges. Thus to reward a broker-dealer firm which is only a member of a regional stock exchange for its sale of mutual fund shares, the fund's investment adviser may instruct a dual member to execute an order for a dually traded security on the regional exchange, and to give up a portion of its commission to the regional-only member firm. Such a give-up is consistent with the

---

[256] See ch. VI.I.2.b(1).
[257] See ch. VIII.D for a discussion of the over-the-counter market in exchange-listed securities.

rules of the regional exchanges; indeed three regional exchanges [258] permit commission splitting with NASD members which are not exchange members. Although the regional exchanges also have minimum commission rate schedules, which are no higher than those on the NYSE, and their executions are in large measure closely geared to executions on the NYSE, the channeling of reciprocal business through the regional exchanges can also raise questions of conflict of interest. Not only is there always the question whether better terms might be available in the over-the-counter market, but certain practices, such as the "keep in line" order,[259] can sometimes raise a question whether a given execution on the regional exchange in an NYSE stock is as favorable as what might have been obtained on the NYSE. A troublesome aspect of such a conflict of interest is the difficulty in ascertaining whether in each instance the conflict is being properly resolved in favor of the fund's shareholders.

As suggested in chapter VIII.E, reciprocal business is an important aspect of the functioning of regional exchanges. Most of the issues which they trade are also listed on the NYSE. Two-thirds of the four largest regional exchanges' "sole" members (those not members of other exchanges) reported participating in reciprocal business arrangements, and over 60 percent of these participants attributed to such arrangements one-fifth or more of their total exchange income.[260] The major single source of reciprocal business income from institutional investors to the regional exchange firms is probably mutual funds. They were, for example, responsible for $14.9 million of the total of $22.4 million in transactions executed on regional exchanges in April 1962 by the various institutional investors which reported such transactions to the Special Study; when issues listed only on regional exchanges are eliminated from the totals, funds were responsible for $14.5 out of $20.9 million in reported transactions (tables VIII–20 and VIII–20d). On a percentage basis, mutual funds reported transactions on regional exchanges in dually traded stocks in April 1962 which had an aggregate dollar value equal to 9.2 percent of the dollar value of their NYSE transactions in stocks during that period, while no other institutional investor had a percentage higher than 2.6. It would appear that funds and their managers make deliberate use of the regional exchanges in allocating their portfolio brokerage for reciprocal purposes.

For the broker-dealer firm which is not a member of any exchange, the problem of obtaining the benefit of reciprocal business "earned" through selling mutual fund shares or rendering other services is the most difficult. The problems are illustrated in an exchange of correspondence between a nonmember and the investment adviser of a fund whose shares it had sold. The dealer wrote:

> About 2 months ago Mr. [D. H.] was in our office, and at that time we inquired as to the possibility of receiving from you some reciprocal business in consideration of the business which we had done during the past year. * * * Mr. [H.] advised that, normally, whenever a firm had done at least $25,000 business a year they tried to give them some reciprocal business, and he would make it a point to see that we received some.

---

[258] The Pacific Coast Stock Exchange, the Detroit Stock Exchange, and the Cincinnati Stock Exchange. See ch. VI.I.1.b(2).

[259] See ch. VIII.E.4.d(1).

[260] See ch. VI.I.2.a(1) concerning the extent of sole members' dependence on reciprocal business.

In its reply the investment adviser said:

> We would be delighted to place reciprocal business with your firm but since the greater part of our activity is in stocks listed on the New York Stock Exchange it is difficult to get business to a nonmember firm unless they have a correspondent or a member house that they wish to favor. Otherwise we can only wait until there is a new offering which we decide to buy and we can then ask the underwriters to include certain dealers for selling group participation, the stock of course to be taken by us.
>
> * * * * * * *
>
> No one has a preferred position. Sooner or later we will be able to show our appreciation of what you are doing for us. If you have any ideas or suggestions I should be pleased to hear them.

Some months later the dealer renewed its request:

> It has been approximately 6 months since we first wrote to you after talking to your Field Representative, Mr. [D. H.].
>
> We appreciate the fact that it is more difficult for you to give us reciprocal business, since we are not New York Stock Exchange members, but we had hoped that by this time there would have been some occasion in which, either through new underwritings or after market offerings, that you might have been able to throw some business our way. Your portfolio shows holdings of various unlisted stocks, so we are still hoping that you may accomplish the above.

The adviser replied:

> We have your firm in mind for the first opportunity that develops where we can place your firm in a selling group in a new issue where we could be buying. Also any after-the-market offers where it can be done. We try to work out such an arrangement but quite frequently at the last minute the underwriters are unable to deliver.
>
> I can assure you we very much appreciate your interest in our behalf and are continuing our efforts to find some way of showing this appreciation in a more concrete manner.

These letters suggest some of the problems involved in allocating funds' reciprocal business to over-the-counter dealers and some of the methods which have been used to accomplish that end. The reason reciprocal business is difficult, legitimately, to give to nonmember broker-dealers is the ability of funds and their advisers to deal with the primary market makers in their acquisition and disposition of blocks of stock in the over-the-counter market. There are relatively few wholesale dealers making markets in securities of institutional interest as compared with the number of firms selling mutual fund shares. In the over-the-counter markets commissions and markups are subject to negotiation, and mutual funds dealing directly with primary market makers can often execute transactions at wholesale prices, a benefit not usually available to individual investors. Most funds or their advisers have their own trading or order departments [261] with employees versed in the intricacies of over-the-counter trading who, in the words of one fund, maintain "* * * personal telephone relations with a very large number of brokerage firms * * *" and "* * * have a continual knowledge of the most advantageous markets. * * *" Under these circumstances splitting over-the-counter orders among a number of small over-the-counter dealers is not justifiable because of the higher cost of execution which would generally result. The mutual fund industry has, nevertheless, devised several

---

[261] All of the 16 load funds and 5 no-load funds to which questionnaire IN-4 was sent reported that they or their investment advisers or managers had established special trading or order departments for supervision of portfolio transactions.

methods by which it can spread the benefits of reciprocity to nonexchange member broker-dealers.

One technique is referred to in the correspondence quoted above. Fund managers sometimes arrange to have nonexchange member dealers included in the selling group of a new underwriting of an issue, some of whose shares the fund intends to purchase, or a secondary offering of an issue which the fund intends to purchase or sell. In this type of reciprocal business the dealer is required to do nothing except receive a check from the managing underwriter for its share of the selling group concession. The managing underwriter handles all details of bookkeeping and the delivery of the shares. The fund, at the same time, incurs no additional expense through the use of a number of dealers acting as members of the selling group, since the price of the shares and the spreads have already been fixed by negotiation between the issuer and the managing underwriter. If a fund participated in such offerings primarily in order to reward nonexchange member dealers, a conflict of interest would be created, but it would be very difficult to determine the existence of any such conflict.

Another device occasionally used to extend the benefits of reciprocity to nonexchange members is known as a "trade-off." Under this arrangement a fund manager directs NYSE-listed business of the fund to an Exchange member firm with a request that the Exchange firm in turn direct over-the-counter transactions to nonmember firms designated by the fund.

Probably the most common method of benefiting nonexchange member dealers, however, is the so-called service give-up. Under this arrangement, the fund manager will direct the NYSE member firm serving as its primary broker to give up a portion of its commission to a second NYSE member firm, which in turn renders services to the nonmember. The services rendered by the member to the nonmember firm are most frequently the sales promotion services discussed in the preceding section, and the pressure to reciprocate nonmember dealers through some method has undoubtedly contributed to the growth of the sales promotional services produced by the five member firms there referred to. The preponderance of the services provided by those firms is in exchange for commissions or commission credits rather than for cash, and the estimate by a partner of one of those firms that his firm provides its services to 40 percent of the mutual fund industry suggest the widespread use of the service give-up. As might be expected, some of the nonmember dealers would prefer to receive the reciprocal business to which they feel entitled in cash rather than merchandise. One such dealer wrote to the Commission:

> A nonmember dealer (not NYSE) works his head off to create millions in brokerage business—and services the funds' clients for years and years in dozens of ways but can't get cash for this extra service. This is wrong!

In their efforts to provide cash compensation to nonmember broker-dealers to reciprocate for the sale of fund shares, some funds and their advisers turn to practices in transactions in over-the-counter securities which resemble the give-up in exchange transactions. The use of the give-up in over-the-counter transactions, however, poses conflicts of interest which do not exist in the present framework of the exchange markets because of the absence of a minimum commission rate structure. In the over-the-counter market a give-up by an executing broker

to another broker inevitably raises the issue of whether the fund involved obtained the best possible price in the transaction. Despite a general awareness by most funds of the obligation to their stockholders to obtain the best possible terms in all transactions, situations came to the attention of the study suggesting that this objective is not always achieved when over-the-counter securities are bought or sold.

An example of an outright over-the-counter give-up occurred in connection with the purchase by one mutual fund in June 1961, of 12,900 shares of Bell & Howell, an NYSE-listed stock, through an over-the-counter firm. The firm, acting as agent for the purchasing fund, acquired the block of shares from a second fund and charged a commission of $5,800 to the first fund at the NYSE rate. Its confirmation noted that it was "a designated sale," and that the firm would participate in the commission only for a total of 6,450 shares and would confirm and deliver. The balance of the commission was shared in by 14 other nonmember firms. While the fund acquired its block of listed stock at the Exchange commission rate, the broker's willingness to give up half of its commission suggests that the fund could have acquired the block for substantially less.

Another method of accomplishing an over-the-counter give-up is by interposing a selected nonmember broker-dealer between the primary broker and the fund. One member of the industry has described the practice as—

> * * * where a fund will go to a primary market and locate stock, and then go to secondary firm and say, "we want such and such a security, and if you go to firm A, which is the primary market, you can get it at a certain figure"; and then have the secondary firm [confirm] at a commission or markup of some sort.

A concrete example of interpositioning in over-the-counter transactions which came to the attention of the NASD in 1959 involved a Boston mutual fund underwriter, one of the funds it underwrote, and a retail specialist in mutual fund shares. In one of the questionable transactions, which involved the sale of an over-the-counter oil stock held by the fund, the fund underwriter instructed the retailer to sell 4,000 shares of the stock and simultaneously gave it the name of an NYSE firm which would purchase the shares. The NYSE firm took delivery of the share certificates directly from a bank designated by the underwriter and sent a check for the proceeds directly to the fund, after deducting a commission for the retailer, who received $800 for his "services."

Although the Special Study found no widespread incidence of give-ups in the over-the-counter market in listed securities,[262] responses to one questionnaire indicated that a few firms had sometimes provided give-ups or interposed other firms when acting as principal or agent in the over-the-counter purchase or sale of NYSE-listed securities. Some of the firms indicated that such transactions were against their present policies, and that they had occurred inadvertently or prior to institution of their policies. One firm apparently viewed the over-the-counter give-up as raising no problems so long as the fund paid no more than it would have paid as an NYSE commission in a transaction executed on the Exchange. The firm stated:

> If our "customer" is an institution who wishes to enable an NASD member to obtain a commission (or a fraction of the regular commission) we are willing

[262] See ch. VIII.D.6.d.

to confirm the transaction to the NASD member designated by the institution. We assume that the institution who wishes to direct such commission business to an NASD member exercises due care to insure that the cost to the institutional beneficiaries does not exceed that which they could be reasonably expected to sustain had the order been executed through an NASD broker-dealer who is also a member of the NYSE.

It is our supposition (unsubstantiated by any direct evidence) that our institutional "customer" wishes to offer "reciprocation" to the designated NASD broker-dealer for benefits accruing to the institution from that broker-dealer's efforts.

The firm, which specialized in over-the-counter transactions in NYSE-listed stocks,[263] solicited mutual fund business by pointing out that reciprocal business can be directed to a wider range of retail fund dealers at prices equal to or better than those available through NYSE members. According to one of its partners, some funds accepted this point of view while others rejected it as violating their directors' duty to seek executions at prices most favorable to fund shareholders.

On occasion, the interposed broker-dealer has been an affiliate of the fund's investment adviser or underwriter. In such a case the conflict of interest with the fund shareholders is most obvious. Instances of interpositioning of this kind have occurred in connection with over-the-counter transactions of Institutional Shares, a fund affiliated with the Channing Corp. For certain over-the-counter transactions, traders for the fund dealt directly with the primary market maker, and each purchase or sale was confirmed directly to the fund. For other transactions, some involving the same securities, the traders transmitted their orders on behalf of Channing Service Corp., an NASD member wholly owned by Channing Corp., which would execute the transactions with a primary market maker and receive commissions on the transactions. The indifference of the primary market maker to such interpositioning is illustrated in the testimony of a trader for one of the large wholesale market makers:

A. * * * See, to me, Channing is essentially a name. It's what we call a good name because when we deliver stock it gets paid for. That's all that Channing means to me.

Q. In other words, whenever you speak to [the Channing trader], you don't know whether you are speaking to Institutional Shares or Channing Service?

A. In terms of an execution of a trade, yes, that's true.

* * * * * * *

Q. At the time the order is placed, does he tell you who the transaction is for, Institutional or——

A. He does not.

Q. He only tells you after the trade is actually consummated?

A. That's correct.

Channing's interpositioning of Channing Service in Institutional Shares' over-the-counter transactions has led to the prohibition of the sale of shares of that fund in the State of Illinois.[264] Channing, on the other hand, does not interpose Channing Service in transactions between its Managed Funds and primary market makers. The differing treatment was explained by an officer of a Channing affiliate as follows:

* * * Managed Funds had many thousands [of shareholders] in the State of Illinois. It was very vital that we operate in Illinois. So I as sales manager

---

[263] This firm, while active during the course of the study, had ceased operating in the off-board market by May 1963.

[264] See the discussion of State regulation of reciprocal business in sec. 3.a, below.

pointed out that we had to service the accounts, * * * and therefore * * * Channing Service should not take any commission.

Other instances of interpositioning affiliated broker-dealers have come to light in mutual fund inspections carried on by the Commission under the Investment Company Act. In effect they represent the carrying of practices arising out of the reciprocal business pattern full circle to an extreme of self-dealing.

3. THE REGULATION OF RECIPROCAL BUSINESS PRACTICES

The widespread use of reciprocal business to reward the sale of mutual fund shares can give rise to pressures which can cause concern for the protection of the public. Fund advisers and underwriters, which benefit most directly from increased sales of fund shares, are subject to a continuing temptation to stimulate such sales by the offer of special or extra reciprocal business as added compensation, and fund retailers offered such additional compensation may, in recommending the purchase of funds to their customers, in some cases overlook their relative merits in favor of more tangible sales incentives. The extent of allocation of portfolio brokerage in unusual amounts in the industry was beyond the power of the Special Study to determine, but it did obtain indications of the use of special allocations to reward sales campaigns, stimulate sales interest and establish good will with particular dealers, as well as evidence of extraordinary compensation paid directly to salesmen and supported by reciprocal business. The NASD's Investment Companies Committee discussed the problem in its report to the Board of Governors in November 1961, in the following language:

> Since our last report on reciprocal business, a number of developments have occurred which have made it imperative that this subject receive prompt action. One of these has been the increased tendency of certain underwriters to arrange for the direction of abnormally large amounts of brokerage business, either directly or through give-ups, to certain firms for the apparent purpose of inducing or rewarding extra sales effort on the part of those firms. In our view such a practice is fraught with danger, and we believe that it is essential that a practical means be found to throttle the practice before it reaches more dangerous proportions.

The pressures created by reciprocal business, whether arising from the desire of fund advisers and underwriters to induce extraordinary selling efforts or from the demands of broker-dealers for extra compensation, contain the seeds of the additional risk that transactions will be made in fund portfolios in order to generate brokerage for reciprocal business. The problem again has been described by the NASD's Investment Companies Committee in the following manner:

> The potential problem, then, may be said to arise primarily from the fact that eagerness to raise capital may overcome management's sense of fiduciary responsibility by encouraging an unnecessary turnover of portfolio securities or executions of purchases and sales at prices or brokerage costs which are not the most advantageous to the investment company.

Portfolio churning is a clear abuse of fiduciary duty on the part of fund directors. Its practice is particularly pernicious because it is so difficult to detect. Fund turnover rates may provide few clues to its existence since fund investment philosophies and practices may vary widely within a perfectly legitimate range of appropriate business judgment. The detection of portfolio churning involves the determination of motivations which may be impossible to establish.

Despite the deep-rooted nature of the problems which arise from reciprocal business practices, however, some attempts have been made by the various regulatory agencies to curb particular tendencies and abuses which have arisen.

a. Regulation by State securities administrators

Among the first to recognize reciprocal business as a practice giving rise to regulatory problems was the North American Securities Administrators (NASA; formerly known as the National Association of Securities Administrators), an organization of the blue sky officials of the various States. As early as 1949 the association adopted a resolution disapproving attempts to promote the sale of mutual fund shares through agreements to give dealers brokerage business "in addition to the usual contractual allowances." The resolution was not, however, directed at transactions between a fund and a broker-dealer selling shares of a fund in the absence of a promise or agreement. In 1952 the NASA supplemented its original resolution with two other specific prohibitions. The first forbade "stockpiling" of give-ups by investment companies, a practice by which funds accumulated backlogs of give-ups which they used selectively among broker-dealers. The second prohibited give-ups where they resulted in the failure of a fund to receive the most favorable price in a transaction, as in an over-the-counter transaction.

These resolutions have subsequently become the basis for regulations adopted by a number of States under their securities laws.[265] Informally known as the "Bewares," the NASA resolutions also became the starting point for all subsequent regulation of reciprocal business. Their impact on industry practices is limited by the problems of enforcement which hamper most State securities administrators, but shares of funds which have engaged in prohibited practices are forbidden to be sold in some States.[266]

b. Regulation by industry organizations

The NASD's Investment Companies Committee has, as previously indicated, for some time expressed concern over the problems arising from reciprocal business practices. It participated in the drafting of the NASA resolutions described above, but not until 1957 did it begin considering similar proposed rules applicable to its membership. To date, however, the only final results of its deliberations have been the adoption by the Board of Governors in 1960 of an interpretation of the Rules of Fair Practice with respect to "Special Deals."[267] The interpretation deems it conduct inconsistent with just and equitable principles of trade for a principal underwriter to give a member or a registered representative "anything of material value in addition to the discounts or concessions set forth in the currently effective prospectus of the investment company." Despite its broad language the interpretation is not intended to apply to customary reciprocal business practices.

The NASD has never proposed a regulation relating to stockpiling or to over-the-counter give-ups. Although the Investment Companies Committee included a prohibition of these practices in an early draft

---

[265] Alabama, Kentucky, Maine, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, North Dakota, Ohio, Oregon, South Carolina, West Virginia, and Wisconsin. In addition, Illinois has adopted the substance of the resolutions.

[266] See the discussion of Channing Service Corp. in sec. 2.b, above.

[267] NASD Manual, p. G-32.

of a proposed rule, in 1961 it concluded that it was beyond the proper scope of NASD activities to—

* * * control the manner of execution of portfolio transactions of investment companies, except to the degree that the activities of our members are already controlled under the present Rules of Fair Practice * * * [or] attempt to enforce the obligation of investment companies to seek the so-called "best" markets.

The Board of Governors has apparently concurred in this view.

In May 1961 the NASD did request the Commission's tentative approval of proposed amendments to its Rules of Fair Practice which would have prohibited (1) promises for any specified amount of brokerage business, (2) the allocation of brokerage business to any firm in an amount "greater than or disproportionate to the amount of brokerage commissions generally directed to other members in relation to their sales volume, * * *" and (3) the direction of commissions to particular salesmen of member firms. In addition, the NASD proposed to require its underwriter members to "compile and maintain detailed information" on the portfolio transactions and brokerage commissions of the mutual funds for which they act.[268] The staff of the Commission took the position that while the proposed rules would eliminate some undesirable practices, there was a question as to whether they went far enough, and they would appear to codify and thus impliedly approve the allocation of brokerage commissions as additional compensation for the sale of fund shares. The Commission indicated its informal approval only with respect to the proposed provisions relating to inducements to individual salesmen and gathering information on reciprocal business practices. In view of the commencement of the Special Study and the subsequent organization of the Commission's special unit or investment companies, the NASD has gone no further in its development of amendments of its rules in the reciprocal business area. It has, however, undertaken a broader inspection program for mutual fund underwriters, and has begun to gather information through this source on reciprocal business practices.

Despite the extensive participation by NYSE members in sales of mutual funds and reciprocal business practices, the Exchange's interest in the subject appears to have been limited to a consideration of problems relating to its antirebate rule. Its activities in connection with the dealer promotion services which its members may render to nonmembers for commission business without violating that rule are described above.[269]

While the Investment Company Institute is not a self-regulatory organization in the sense of having the power to impose sanctions on its members, it is an industry group of substantial importance in the investment company industry. It is appropriate to note, therefore,

[268] Joined with the request was a proposal to expand the category of outlawed "special deals" by prohibiting underwriters' giving to fund dealers options on management stock at substantial discounts as additional sales inducements or rewards. Although this broadening of the interpretation was prompted by a Commission request to examine the propriety of such practices, the Commission took no action on it. The staff of the Commission had argued that the proposal should not be supported since it failed to include arrangements between underwriters and between sponsors and underwriters, and, since it specifically exempted customary reciprocal business practices, Commission approval might be taken as acceptance of the propriety of such practices. Virtually the same provision has been included as a specific rule in the NASD's current proposed revision of its Rules of Fair Practice. (See ch. XII.G.)

[269] Sec. 2.a(2).

that the "Guide to Business Standards" adopted by its members in 1962 contains a section relating to reciprocal business. Section 4 of the guide states that no member should "promise or intimate to a broker-dealer" that he will receive a certain amount of brokerage commissions "directly or indirectly," and that no member fund should arrange for allocation to a broker-dealer of commission business which is disproportionate to that firm's sales of the fund's shares "without specific disclosure in the effective prospectus." The section also enjoins member funds from directing broker-dealers to give up a portion of their commissions in over-the-counter transactions.

c. Regulation by the Commission

Apart from the Commission's consideration of proposed NASD rules relating to reciprocal business, the Commission's approach to the problems it raises has been principally based until recently upon enforcement of the disclosure requirements of the Securities Act of 1933. The Commission requires that every fund prospectus provide, where applicable, an explanation of the fact that commission business from the fund's portfolio transactions is distributed to dealers which sell fund shares. The disclosure is usually made in fairly general terms.

A recent expansion of the inspection program of registered investment companies conducted by the Commission's regional offices, under the supervision of the Division of Corporate Regulation, should provide considerable information on reciprocal business practices of individual companies and the industry in general. To implement the new program the Commission adopted a rule, which became effective on February 1, 1963, prescribing the records which must be kept by registered investment companies and certain related persons.[270] The rule requires maintenance of current records on fund transactions in portfolio securities, with separate ledger accounts for "each broker-dealer, bank, or other person with or through which transactions in portfolio securities are effected.[271] Particularly related to reciprocal business is the requirement that funds keep—

> A record for each fiscal quarter, which shall be completed within 10 days after the end of such quarter, showing specifically the basis or bases upon which the allocation of orders for the purchase and sale of portfolio securities to named brokers or dealers and the division of brokerage commissions or other compensation on such purchase and sale orders among named persons were made during such quarter.[272]

This provision also requires that the quarterly record shall—

> * * * indicate the consideration given to (i) sales of shares of the investment company by brokers or dealers; (ii) the supplying of services or benefits by brokers or dealers to the investment company, its investment adviser or principal underwriters or any persons affiliated therewith; and (iii) any other considerations other than the technical qualifications of the brokers and dealers as such. The record shall show the nature of the services or benefits made available, and shall describe in detail the application of any general or specific formula or other determinant used in arriving at such allocation * * * and division of brokerage commissions * * *.

The Commission's Division of Corporation Regulation has under consideration recommending to the Commission an expansion in the

---

[270] Rule 31a-1.
[271] Rule 31a-1(b)(2)(C).
[272] Rule 31a-1(b)(9).

annual reporting requirements of investment companies and certain related persons which would include, among other things, information as to reciprocal business practice.

4. SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Reciprocity, or "doing business with people who do business with you," is an accepted custom of the business world in general, and the securities industry is no exception. In the mutual fund industry, however, it takes on a unique characteristic. While it is the mutual funds themselves whose portfolio transactions provide the brokerage which constitutes the currency of reciprocity, its principal beneficiaries are not the funds but their investment advisers and principal underwriters.

The unusual structure of reciprocal business practices in the mutual fund industry traces principally to the minimum commission rate schedule of the New York Stock Exchange and its antirebate rule. The large volume of transactions executed by mutual funds in the Exchange market are sufficiently profitable to the member firms which handle them that these firms are willing to do so for 40 percent of the amount to which the commission rate entitles them. Since the balance of 60 percent cannot be returned to the fund themselves without violating Exchange rules, the executing broker-dealers pay give-ups, as instructed by the funds or their investment advisers, to other member firms. The firms to which the give-ups are paid are those which have rendered services in some way related to the fund, their advisers or underwriters. The principal service so rewarded is the sale of fund shares, others include such things as rendering statistical or research services or providing wire facilities. The funds do not profit from the sale of their shares and they pay an advisory fee—geared to their size—for the investment advice they receive from their advisers. The rewards of reciprocity thus flow to the broker-dealers who have primarily benefited the advisers and their frequently related principal underwriters rather than to the funds.

While the rules of the New York Stock Exchange have created the particular character of reciprocal business in the mutual fund industry, the problems are not confined to the community of NYSE firms. Nonmember firms are as eager for additional compensation for their sales of fund shares as are member firms. As a result there have developed intricate patterns which permit them to share the large amounts of brokerage generated by the funds. Firms which are members of regional exchanges are enabled to participate through transactions on those exchanges in dually traded securities executed by firms with dual memberships. For firms which are members of no exchange the problem is more difficult. Sometimes they are rewarded by participating in a selling group in a primary or secondary offering of a security to be purchased or sold by the rewarding fund. More often they are required to take their compensation in kind rather than cash through a service give-up from a NYSE member firm of sales promotional or training materials. On occasion they may receive over-the-counter give-ups, directly or through a device known as interpositioning. Such over-the-counter give-ups, including interpositioning, raise serious questions of conflicts of interest, however, since, in the over-the-

counter markets where no minimum commission structure exists, there is no reason why fund shareholders rather than secondary broker-dealers should not be entitled to the benefits of quantity discounts.

The existence of substantial sums of fund portfolio brokerage available as extra compensation for the sale of fund shares can lead to undesirable sales pressures by fund retailers. Competitive demands or a desire to increase investment advisory fees can lead to portfolio churning by investment advisers. Both possibilities have concerned industry representatives in recent years.

Ultimately the solution of the problems lies at their source: the NYSE minimum commission rate schedule. So long as the funds cannot themselves benefit from the economics created by their mass purchasing power, the complexities and potential problems of the third-party beneficiary system will continue. Various problems in connection with the Exchange's rate structure are discussed in chapter VI, but it is appropriate to observe in connection with this review of reciprocal patterns of mutual fund brokerage allocations that in the consideration of any revision of the rate structure the question of introducing some form of volume discount should be high on the agenda.

Granting that the existing commission framework may explain many of the existing patterns of reciprocity, there are some which it cannot justify. There is no reason for funds or the regulatory agencies to countenance give-ups in the over-the-counter market. The NASD should outlaw participation in them by its members and discipline such violators as come to its attention. The prohibition should cover over-the-counter transactions in listed securities as well as unlisted ones, and should be designed to prohibit its evasion by deliberate resort to a market for the purpose of taking advantage of a minimum commission rate structure.

The Special Study concludes and recommends:

1. The pattern of reciprocal business in the mutual fund industry is unique. The economies of the volume of securities transactions generated by the mass purchasing power of the funds for the most part are of minor benefit to the funds themselves. The primary beneficiaries are their investment advisers and their frequently related principal underwriters, who to a large extent use reciprocity to reward the sales efforts of fund retailers, thereby increasing their own rewards. The use by fund advisers of investment advice and research provided by brokerage firms in return for fund brokerage, without diminution of their investment advisory fees, is another indication of the manner in which they are the primary beneficiaries of reciprocal business. This unbalanced reciprocal structure is a direct outgrowth of a minimum commission rate structure which prohibits volume discounts and rebates. In the broad study of the commission rate structure recommended to the Commission in chapter VI–I, appropriate consideration should be given to the desirability and appropriate form of a volume discount from the viewpoint of mutual funds.

2. While some reciprocal practices in the mutual fund industry are justifiable under the existing commission structure, the over-the-counter give-up in its various forms, including interpositioning, is in flagrant conflict with the duty of a fund and its adviser

to obtain best terms in its securities transactions unless the advantages of any such give-up can be clearly demonstrated. The NASD should amend its Rules of Fair Practice to prohibit the practice among its members in over-the-counter transactions in any security. The Commission should consider the issuance of a Statement of Policy on the subject.

3. Mutual fund directors and those who transact portfolio business for them are primarily obligated to obtain the best available terms in such transactions for the benefit of fund shareholders without regard to the reciprocal business aspects of the transaction, and to see that the funds themselves receive the maximum benefits available from any such reciprocal business. The choice of market for portfolio transactions should be made exclusively from the point of view of these obligations, and not on the basis of rewarding broker-dealers for their sales of fund shares or for other services. The NASD and the Investment Company Institute should promulgate rules and standards of conduct designed to assure that the primary obligations to fund shareholders in the handling of fund portfolio transactions are recognized and enforced.

D. Insider Transactions in Portfolio Securities

The high rate of portfolio turnover of mutual funds compared to that of other institutional investors has been noted elsewhere in this report.[273] The market impact of the mutual fund transactions involved in such turnover is variable and not wholly predictable, but the purchase of a large block of any given security in the market over a fairly brief period of time obviously may have a tendency to increase the price of the security, and conversely a sale of a large block may have a tendency to decrease the price. Those persons who are in a position to know in advance of projected acquisition or disposition by a mutual fund of a block of shares are therefore in a position to profit through anticipating the fund's action in trading for their own accounts. Taking advantage of inside information in advance of fund transactions for personal gain is widely regarded in the industry as unethical. The Investment Company Institute in 1962 promulgated a "Guide to Business Standards" which adjures the officers, directors, and employees of its member investment companies or investment advisers having such information to take no action "which is inconsistent with such [persons'] obligations to the investment company." The nature and extent of insider trading, the policies of the investment company complexes concerning it, and the implementation of such policies are the subject of this section of the report.

1. SCOPE AND METHOD OF STUDY

The study of insider transactions commenced with a study of the portfolio transactions of 51 open-end investment companies[274] during the 7-month period from December 1, 1960, through June 30, 1961, a period of heavy activity in a rising market. The principal factors

[273] See ch. VIII.C.5.
[274] The 51 companies are listed in table XI-12.

in the determination of the funds selected were representation of the industry in terms of total assets, range of asset size, and diversity as to sales methods, type of sales organization and fund objectives. The net assets of the 51 funds aggregated $14.9 billion as of December 31, 1961, an amount equal to 65.4 percent of the assets at that date of the 169 open-end investment companies which were members of the Investment Company Institute.[275] The selected funds ranged in size as of December 31, 1961, from $1.4 to $1.9 billion, and included funds sold exclusively through captive sales forces, funds sold through distributors and independent broker-dealers, no-load funds, balanced funds, growth funds and speciality funds. Each fund was requested through a questionnaire designated "IC–1" to supply the names of its investment adviser, its principal underwriter, any affiliated broker-dealer [276] and any persons having access to the investment decisions of the fund, including officers, their assistants, directors, partners, trustees, advisory board members, principal stockholders, account executives, analysts, traders, and others connected with the fund, its investment adviser, its principal underwriter, and affiliated broker-dealers.[277] In addition each fund, investment adviser and principal underwriter was asked to describe its policy respecting the use of investment advisory information supplied to the fund or of information concerning prospective portfolio transactions, and its procedures and experience in enforcing such policy. Finally each fund was requested to supply on form A a summary of its portfolio transactions during the indicated period.

The responses of the 51 funds revealed a maximum of 154 portfolio issues traded by a fund during the period, a minimum of 21, and an average of 70. They also showed an aggregate of 2,000 related or affiliated persons, firms and companies. From a study of these initial responses, 28 of the original 51 funds were selected to give more detailed information on insider transactions.[278] Again the principal factors in the selection were representation of the industry in terms of total assets, range in asset size, diversity in sales methods and type of sales organization, and fund objectives. These 28 funds had aggregate net assets at December 31, 1961, of $5.2 billion, or 22.8 percent of the assets of the 169 Investment Company Institute member open-end companies. They had named an aggregate of 946 related companies and access persons (after elimination of secretaries, clerks, and similar minor employees). Each of these persons and companies was required to supply information on form B or C of questionnaire IC–1 [279] with respect to his or its transactions in certain securities in which the related fund had executed transactions. These securities were selected on a 50-percent sampling basis. An analysis was made on the basis

[275] See ch. I, table I–20, p. 37 (pt. 1).

[276] In questionnaire IC–1 an affiliated broker-dealer was defined as any broker-dealer which is an affiliated company or person of the investment company, its investment adviser or its principal underwriter, or of which any affiliated person of the investment company, its investment adviser or its principal underwriter is an affiliated person. "Affiliated person" was defined in the language of the Investment Company Act (sec. 2(a)(3)) and included an owner of 5 percent or more of outstanding voting securities, a person or company directly or indirectly controlling, controlled by, or under common control with another person or company, and affiliation through being an officer, director, partner, copartner or employee of another company.

[277] For the purposes of questionnaire IC–1, these "others" were persons whose position or relationship with the investment adviser, principal underwriter or affiliated broker-dealers was "such as to afford access to information as to recommended, proposed or pending portfolio transactions of the investment company prior to public disclosure thereof."

[278] The 28 companies are set forth in table XI–12.

[279] Form C was directed to investment advisers and form B to all others.

of responses from 878 persons and companies received as of September 14, 1962, an arbitrary cutoff date selected by the study.

Following a review of insider trading of the 28 funds, it was deemed desirable to obtain from 8 of them on form D further detailed information as to the funds' transactions, including prices, exact trade dates, dates of written recommendations and dates of investment decisions, and the identity of persons making the recommendations and decisions.

2. INSIDERS' TRANSACTIONS AND CONFLICTS OF INTEREST

Before reviewing the results of the study's survey of insiders' transactions, it is necessary to consider the situations in which conflicts of interest may and may not exist. Clearly, not every transaction by an insider in a security held in the portfolio of a fund involves a conflict. On the other hand, certain transactions may be measurably or immeasurably adverse to the interests of the fund.

This report has noted that by far the most common way of accomplishing executions in listed stocks by institutions, including mutual funds, even when large block purchases or sales are used, is through a series of relatively small individual executions in the regular auction market on the floor of an exchange.[280] Similarly, block transactions in unlisted securities are frequently accomplished by a series of purchases and sales through the regular over-the-counter markets maintained by dealers. Whenever a fund transaction in a particular security is so carried out through regular market channels, it may be expected to have some impact—slight or substantial, temporary or lasting—on the market price of that security. A fund decision to purchase will increase the demand for the particular shares, and therefore will have a tendency to increase the price or at least retard a decline. A fund decision to sell, by increasing supply, will have a depressant effect on market price. The degree of impact will naturally vary, depending upon many factors such as the amount of outstanding stock, the number of shares normally traded, interest of others in the same issue at the same time, and the general course of the market. Transactions by insiders will exhibit the same tendencies, but to the extent that the transactions themselves are smaller their market impact will be less.

Whenever an insider having knowledge of an expected transaction of a fund in a particular security executes orders ahead of the fund but consistent with its anticipated course, he may be presumed to be to some degree in a position of potential conflict. If he buys before the fund buys, he may raise the price to the fund; if he sells before the fund, the fund may realize less from its sale. The number of shares and dollars involved in the insider's transaction will be material to a consideration of the amount of market impact and the possibility of an abuse of trust, but it does not affect the principle that there is a conflict. As set forth by one investment adviser in its statement of policy:

> Any contention that such purchases or sales may have no effect on market price is without merit.

[280] See ch. VIII.C.

Not all potential conflict situations are susceptible of easy analysis, however. An investment adviser to a fund which has more than one investment advisory client will have obligations to all his clients. The establishment of a system of priority of obligations may be difficult, while the accomplishment of parity of treatment may create other problems. The simultaneous purchase by one client or fund and sale by another may raise questions about the justification for conflicting advice.

Insider trading, whether preceding, simultaneous with or following fund trading, can raise questions relating to section 17(d) of the Investment Company Act. Rule 17d-1 prohibits, among others, a director, officer, or employee of a registered investment company or of its investment adviser, from "participat[ing] in or effect[ing] any transaction in connection with any joint enterprise or other joint arrangement or profit-sharing plan in which * * * [the investment company] is a participant * * *" unless application has been made to and approved by the Commission in advance of the transaction, and sets forth the standards the Commission will consider in passing upon such applications: (1) whether the participation of the investment company in the joint transaction "is consistent with the provisions, policies, and purposes of the act" and (2) "the extent to which * * * [the investment company's] participation is on a basis different from or less advantageous than that of * * * [such persons]." In the following analysis of insider trading, however, the Special Study has not considered questions concerning joint enterprises.

Also troublesome is the situation where a person purchases a security before an investment decision has been made by the fund or before a recommendation has even been made that the fund purchase it. Such a person is demonstrating his belief in the correctness of the recommendation, but the demonstration may result in an increased price to the fund. The written statement of policy of one fund resolves this problem in favor of the fund by prohibiting transactions in any security by "an employee who is aware, or has reason to believe, that a security is being, or is about to be, or is likely to be, bought or sold" for its funds.

An insider who purchases or sells a security after his fund has completed its program for acquiring or disposing of that security is obviously not prejudicing the fund's market price, and is also demonstrating his faith in the fund investment decision. Nevertheless, other possible problems exist. Thus, an insider controlling investment decisions of a fund for his own account may be involved in an appropriation to himself of a corporate opportunity of the fund in determining the number of shares the fund may purchase, even though his purchase takes place after the fund purchase and at the same price. For the purposes of its survey, the Special Study has not emphasized trading by insiders which follow fund trading dates.

In its survey of insider trading the study has attempted to determine the extent to which situations of potential conflict exist in the industry, without for the most part characterizing the manner in which they have been resolved. The discussion should not be taken to suggest that the problem of insider trading is confined to the mutual fund industry. Instances have already been cited in chapter III.C of trading by broker-dealers and investment advisers which is

based on advance inside information concerning an issue which is to be the subject of a recommendation to the public, and the problem may also exist where any large institutional transactions are involved.[281] Nevertheless, the results of the survey indicate that considerably more attention to the subject is called for on the part of the mutual fund industry and the regulatory agencies.

3. INSIDERS' TRANSACTIONS—THE INDUSTRY

The study's survey of industry insider trading was based on 878 responses of persons and companies in some way connected with the 28 funds selected for the survey. Of the 878 there were 232 individuals, 13 investment advisers, and 19 other companies, including 17 affiliated broker-dealers, who reported trading in the same securities in which their related funds had reported portfolio transactions during the period covered. Respondents reporting such trading constituted 30 percent of all respondents.

To determine which of the insider transactions involved possible situations of conflict, it was necessary first to determine the trading range dates of the funds, or the beginning and ending trade dates during which each fund purchased or sold each security. Insider trading in each security was then classified according to its relation to fund trading range dates. Transactions were classified into those occurring during the fund trading date range, 15 days or less prior to fund trading date range, 16 to 30 days prior to fund trading date range, and more than 30 days prior to fund trading date range. Transactions also were classified into transactions of investment advisers, principal underwriters, affiliated broker-dealers, and all others.[282] Excluded from this tabulation, and noted separately below, are transactions occurring subsequent to the fund trading range dates. The extent of all insider trading in fund portfolio securities during or preceding the fund trading date range, so classified, is set forth in table XI–j below:

[281] See ch. III.C. 8.
[282] Excluded from responses were any transactions of investment advisers who were also broker-dealers in a specialist trading account or in a broker-dealer trading account maintained for the purpose of making a market in an over-the-counter security.

TABLE XI-j.—*Number and percent of related persons or companies of 28 selected mutual funds trading in fund portfolio equity securities when the fund had transactions in the same issue (Dec. 1, 1960, to June 30, 1961)*

Trading period	Total		Investment advisers [1]						Affiliated broker-dealers [1]		Principal underwriters [1]		Other related persons or companies	
			Total		For own account only		For account of others [2]							
	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent	Number	Percent
During fund trading date range	126	14.4	9	32.1	4	14.3	5	17.9	10	31.3			107	13.3
Preceding fund trading date range:														
0 to 15 days	70	8.0	6	21.4	2	7.1	4	14.3	5	15.6			59	7.3
16 to 30 days	45	5.1	4	14.3	1	3.6	3	10.7	5	15.6			36	4.5
Over 30 days	103	11.7	8	28.6	4	14.3	4	14.3	9	28.1			86	10.7
All related persons or companies in survey [3]	878		28						32		14		804	

[1] Where the principal underwriter or the affiliated broker-dealer was the same as the investment adviser, it was included as an investment adviser. There were 14 such underwriters of which 5 reported trades, and 3 affiliated broker-dealers all of which reported trading.

[2] Trading by investment advisers for their 3 largest private accounts managed for a fee and, in the case of 1 investment adviser, also for its own account and for a closed-end investment company.

[3] The figures in each column cannot be added since transactions of some related persons or companies are included in more than 1 trading period and some persons or companies had no trading.

NOTE.—The table includes a 50-percent sample of portfolio equity securities traded by the funds during the period.

As will appear further in this section,[283] it cannot be stated that each trade by an insider within the fund trade date range or 15 days before represents a potential conflict situation. In some situations the trader, though within the definition of an access person for the purpose of the survey, may have had no actual knowledge of the recommended fund transaction, while in others the insider transaction may have taken place on the last or only day of the fund trading date range, but after the fund transaction had taken place. Nevertheless, in a survey covering a representative segment of the industry in almost all respects, and in light of the high position of trust of the persons and companies involved, the overall figures on industry insider trading are significant. In the face of investment company and investment adviser responses to questionnaire IC-1 consistently describing policies which imply prohibition of the use of investment advisory information by insiders for their personal benefit, related persons and companies have traded in portfolio securities fairly extensively. As many as 14.4 percent of all persons and companies solicited had traded in portfolio securities of their funds during the same period as the fund, and 8 percent traded within 15 days prior to the fund. Of the affiliated broker-dealers who were not also investment advisers, 10 out of 32, or 31.3 percent, traded for their own accounts during the fund trading date range, and 5, or 15.6 percent, traded for their own accounts during the preceding 15 days. Of the 28 investment advisers of the funds, 4, or 14.3 percent, traded for their own accounts during fund trade date ranges and 2, or 7.1 percent, so traded in the preceding 15-day period. The figures for investment advisers also highlight the question of conflicts of priorities among categories of clients. Five investment advisers also traded fund portfolio securities for the account of one or more of their top three private investment advisory accounts managed for a fee during the fund trade date range, and four advisers traded for such advisory accounts in the preceding 15-day period.

The classification of transactions in the periods preceding fund trades of course represent arbitrary distinctions made for the purpose of classification. A transaction occurring within a 15-day period preceding fund trades might be quite free of any conflict potential, while a transaction in an earlier period might involve one. While it may be presumed that the possibility of conflict is greatest when the period between an insider transaction and a subsequent fund trade is least, it may be noted that the results set forth in the table also show considerable insider trading in the earlier periods. With respect to trading following fund trades, the data on the transactions eliminated in preparing table XI-j show that of all 878 respondents, 182 or 20.7 percent engaged in such trading. This figure includes 11 of 28 investment advisers (with 6 trading for their own accounts), 13 of 32 affiliated broker-dealers who were not also investment advisers, and 158 of 804 other related persons or firms.

4. INSIDERS' TRANSACTIONS—PROBLEMS AND PERFORMANCE OF PARTICULAR FUNDS

Of the 28 mutual funds included in the survey of the industry pattern of insider trading, 8 were selected for further inquiry from those whose initial patterns raised questions. As indicated above, addi-

[283] See discussion of individual cases in sec. d, below.

tional information was obtained from these funds and their related persons and companies regarding prices and exact transaction dates for both portfolio and insider transactions, dates of recommendations to funds and of investment decisions for them, and the identity of persons responsible for particular recommendations and decisions. Within the limits of time and manpower available to the Special Study, however, it was not possible to investigate each instance of trading by related persons and companies. Therefore, the actual time of transaction, significant when both fund and insider transactions were executed on the same day, was not obtained by the Special Study, and the study had no opportunity to interview the individuals involved in the transactions, recommendations, and investment decisions.

Nevertheless, the insider-trading patterns of five of these firms deserve individual discussion. The analyses of the results of the survey of these five funds must of course be read with a full awareness of the limitations of the inquiry made. It is not intended that the discussion of the transactions of persons connected with any of the five funds should reflect adversely on the funds themselves or even in many cases on the person responsible for the transaction. Explanations may be available for some transactions which on their face raise questions of conflicts of interest. The discussion of the particular funds which follows is not to be considered so much a full exposition of the detailed facts of insider trading as a suggestion of the various types of questions and problems which arise in this area.

a. Leon B. Allen Fund, Inc.

The Leon B. Allen Fund, Inc., a no-load mutual fund with net assets of $1.5 million at December 31, 1962, was organized in 1952 by Gillen & Co., an NYSE member firm which is its investment adviser, and by Leon B. Allen, a partner of Gillen & Co. and president and director of the fund. An analysis of the responses of the fund and its related persons and companies indicate trading for their own accounts by three persons on or immediately prior to the fund trading dates in 13 securities purchased or sold by the fund in the 7-month period from December 1, 1960, through June 30, 1961. The three persons trading were Leon B. Allen, who in each case participated in the investment decision; a director of the fund not otherwise affiliated with the investment adviser and who did not participate in the investment decisions; and "Advisory Account B," one of the three largest private investment accounts managed for a fee by Gillen & Co., the investment adviser. All but one of the securities in which insider trades took place were well-known NYSE-listed stocks.

As to 11 of 13 securities involved, 1 or more of the 3 access persons traded small lots of 30 to 100 shares on the same day or a day or two previous to the date of the fund transaction, which usually involved several hundred to 1,000 shares. The other 2 securities involved insider transactions of less than 200 shares. In most cases the insider trades were at a price advantage ranging from 1/16th of a point to 1 point, and in no case did the fund purchase at a lower price. Without information on the time of executions it is impossible to determine, when the trading took place on the same day, whether the fund transactions or insider transactions took place first. An example of a typical transaction involved purchases of Magnavox Co., on March

10, 1961, a day when 6,100 shares were traded on the New York Stock Exchange. Allen acquired an odd lot at 65¼ and Advisory Account B acquired 100 shares at 65¼, the low for the day. The fund purchased 700 shares at 65¾ and 66, the latter price being the high for the day. It is not known whether the fund purchases preceded or followed the purchases of Allen and Advisory Account B. In two cases, however, where fund purchases continued over several days, and in one case where a fund sale continued over several days, it appears that the insider transactions took precedence.

While neither the fund nor its investment adviser has a written policy on insider trading and use of inside information, they state their unwritten policy to be as follows:

> * * * [I]t would be highly unethical to disclose or use for our own advantage any information concerning prospective, or actual orders for purchase or sale of portfolio securities. * * * The fund buys only well-known securities listed on a major exchange enjoying a broad market. Because of its size the number of shares involved is not large, and any variation in price due to our orders is usually negligible * * *. Violations of our policy would result in immediate dismissal of the person or persons involved.

b. The Chase Fund of Boston

An analysis of the responses filed by this $30.5 million trust and its related persons and companies show trading by 9 access persons in 10 of the securities purchased or sold by the fund, on or immediately before the fund's trade dates. Half of the issues involved were listed on the New York Stock Exchange, while the balance were over-the-counter stocks. The nine persons include three officers, two analysts, and two account supervisors of John P. Chase, Inc., the investment adviser, one officer-director of the principal underwriter, and one trustee of the fund. Although not all of these transactions may have involved conflict-of-interest situations, the problem does arise in the case of at least four of the issues.

On January 11, 1961, the fund purchased 2,000 shares of National Cash Register Co. at prices ranging from 64¼ to 65¼. On the same day an officer of the investment adviser connected with its research department purchased 200 shares at the day's low price of 63¾. Whether the purchase was made after the fund had completed its purchases is not known.

On April 27, 1961, a decision was made to purchase shares of Avnet Electronics Corp., and the fund purchased 10,000 shares during the period from April 28 through May 9 at prices ranging from 44¼, to 58. A second officer of the investment adviser also connected with its research department purchased 100 shares of Avnet on April 28, the day of the fund's first purchase, at 44⅝. In addition, a research analyst employed by the investment adviser purchased 50 shares of Avnet at 48 on May 1, 1961, and sold them on May 5 at 57½.

On January 18, 1961, a decision was made to purchase shares of Helene Curtis Industries, Inc., and the following day the fund purchased 10,000 shares at 30. On the day the decision was made, the research analyst referred to above purchased 100 shares at 29¾. A second research analyst employed by the investment adviser also purchased shares on the day the investment decision was made, buying 200 shares at 29⅝ and 100 at 29¾, and purchased an additional 200 shares on the day of the fund's purchase at prices equal to or above the fund purchase price of 30.

On March 22, 1961, a decision was made to purchase shares of Atlas Credit Corp. for the fund, and on the following day 35,000 shares were purchased at a price of 14. Both of the research analysts who traded in Helene Curtis stock made purchases of Atlas Credit Corp. shares shortly before the decision to purchase for the fund was made. The first had purchased 300 shares on March 17 at 13, and the second had purchased 1,300 shares on March 16 at 12¾ and 600 shares on March 17 at 13.

The Chase Fund of Boston insider transactions raise questions concerning the manner in which funds and their investment advisers enforce the policies which they promulgate. John P. Chase, Inc., the fund's investment adviser, has a written policy which enjoins employees to strict compliance with the following rule:

> No purchase or sale of any security shall be undertaken by any employee or member of his immediate family in anticipation of or during a period when purchases or sales of such security are being made for clients. Any contention that such purchases or sales may have no effect on market price is without merit.

The statement also notes: "As investment managers the firm operates in an area which can be particularly sensitive to ethical and conflict of interest considerations." In describing the means used to communicate the policy to personnel and the procedures for implementing it, the investment adviser wrote:

> For a number of years, periodically, at weekly staff meetings the subject matter contained in the written policy * * * was brought to the attention of all personnel concerned.
>
> We have relied upon the ethical conduct of our personnel in this matter.[283a]

c. Guardian Mutual Fund, Inc.

Guardian Mutual Fund, Inc., is a $16.8 million no-load fund whose investment adviser is Neuberger & Berman, a member firm of the NYSE. Responses in connection with this firm indicate insider transactions by 12 access persons or firms in 28 securities purchased or sold by the fund, on or immediately prior to the fund's trade dates. With the exception of two transactions by one person, all insider transactions were for the accounts of the investment adviser or its individual partners or for one affiliated broker-dealer firm or one of its partners. For the majority of the transactions the account involved

---

[283a] Since the publication of the multilith edition of this report, the Commission has received the following communication from John P. Chase, Inc.:

"If it had been possible for you to investigate the four situations which you have described in the study, you would have learned the following:

"National Cash Register Co.: The officer involved recommended the purchase by the fund before making his own purchase and was informed that his recommendation was not favorably accepted. He thereupon purchased 200 shares for his own account (which he still owns) in the belief that the fund was not going to purchase any of this stock. Later on the same day, the senior officials of the adviser, after checking other recommendations and without knowledge of the officer making the original recommendation, determined to purchase this stock that day and did so.

"Avnet Electronics Co.: The officer of the adviser who purchased 100 shares on the same day that the fund started a series of purchases was not involved in the research recommendations that had been made to the senior officials of the adviser, did not know that a recommendation to purchase such stock had been made and did not know of the fund's decision to purchase such stock. The research analyst who purchased 50 shares was also not involved in the research recommendations, and at the time of his purchase, the fund had actually ceased purchasing the stock and was not then planning to buy additional shares. When the fund recommended purchasing this stock, this analyst was not involved in the decision and it is believed could not have had foreknowledge of it.

"Helene Curtis Industries, Inc.: The fund purchased this stock at a negotiated price directly from a major stockholder. The decision of the fund to make the purchase and the agreed price were fixed before the purchases were made by the two research analysts involved.

"Atlas Credit Corp.: In this instance the fund also purchased the stock at a negotiated price from a major stockholder. At the time the two analysts purchased this stock they could not have had any reason to believe that the fund would subsequently purchase the stock.

"The board of John P. Chase, Inc., and the trustees of the Chase Fund of Boston have each satisfied themselves that none of these four cases which you have cited actually involved any question of conflict-of-interest.

"In the study, there are lengthy quotations from the policy of John P. Chase, Inc., which governs investments of its officers and employees. We think that any full appraisal of the four instances which you have cited would show that such policy has been remarkably well enforced."