

## CHAPTER V

### DISTRIBUTION AND ITS COST

#### A. INTRODUCTION

The mutual fund sector of the investment company industry makes a continuous and a strenuous effort to attract new shareholders and to induce existing shareholders to acquire new shares. This vigorous sales effort pervades almost every aspect of the mutual fund business and is one of its most striking characteristics. The industry's emphasis on sales reflects a structure that stimulates and rewards sales effort. Under that structure the greater the sales, and hence the larger the fund or fund complex, the greater the compensation of its managers.<sup>1</sup>

Sales effort is paid for in a number of ways. The primary means is the "sales load"—the direct selling charge that most mutual fund investors pay when they buy their shares.<sup>2</sup> These charges, which totaled about \$260 million in 1965,<sup>3</sup> are sufficient in themselves to finance a substantial sales effort. Moreover, since the managers of most funds are usually either identical to or closely affiliated with the principal underwriters which have exclusive rights to distribute fund shares, profits from advisory fees, and in some cases from brokerage commissions, can be—and often are—used to subsidize sales efforts in the hope of increasing managerial income over the long run.

The fund's own resources also are used to promote sales. Many funds bear as part of their operating expenses all or part of the cost of preparing prospectuses and sales-oriented shareholder reports as well as certain other sales-related expenses. Most important, as chapter IV explains, a substantial portion of the money that the funds spend for "brokerage" is used to supply added cash compensation to dealers who sell fund shares.

This chapter discusses the more important aspects of mutual fund sales charges and evaluates their fairness. Section B examines the relationship between the sale of new shares and the growth of the mutual fund industry. Section C discusses the prevailing levels of sales loads, allocation of the loads among those who sell fund shares, and the effect of competitive pressures on the loads and their allocation. Section D compares the cost of investing in fund shares with the cost of investing in other types of securities, while section E deals with sales loads on the investment of income dividends distributed to fund shareholders.

Section F discusses statutory controls over sales loads, including the existence of the retail price maintenance provisions of the Act, and presents the Commission's conclusions and recommendations concerning the consequences of and the need for changes in these controls.

<sup>1</sup> See pp. 121-125 *supra*.

<sup>2</sup> See note 123 on p. 52 *supra*.

<sup>3</sup> Source: Investment Company Institute.

Finally, section G discusses the important public policy issues posed by the imposition of front-end loads in connection with the sale of plans for the acquisition of fund shares and of face-amount certificates on an installment basis and presents the Commission's recommendations on these issues.

#### B. MUTUAL FUND GROWTH AND SALES OF FUND SHARES

Mutual funds have three sources of potential growth—(1) income from their portfolio investments; (2) appreciation in the value of their portfolio investments; and (3) capital inflow from the issuance of new fund shares. Since most mutual funds distribute virtually all of their investment income and realized capital gains to their shareholders, capital inflow has been by far the most important source of growth. Such capital inflow comes from (a) the sale of new shares; and (b) the purchase of additional shares by existing shareholders with their dividend income and capital gains distributions.

Since the Act requires that all mutual funds stand ready to redeem their shares at their approximate net asset value: and since virtually all funds regularly receive requests for redemptions from their existing shareholders, some capital inflow usually is necessary if the funds are to maintain their existing size. The industry's emphasis on sales has been viewed as a byproduct of redeemability. This position was expressed by one industry executive who recently stated:

The inexorable law of this business is that when assets rise, redemptions rise proportionately so the more you succeed, the harder you have to sell, just to keep your place on the treadmill.<sup>5</sup>

But sales of new fund shares have enabled the fund business to do more than just keep its "place on the treadmill." Such sales account for most of the increase in mutual fund assets since 1940.

Most sales of fund shares have been made since 1955—the first year in which the value of new shares issued exceeded \$1 billion. Table V-1 shows the relationship between the net assets of the members of the Investment Company Institute ("ICI")<sup>6</sup> and the value of all shares issued and redeemed by them for the period 1955 through 1965. These include shares issued as a result of sales and as a result of investments of dividend income and reinvestments of capital gains distributions. At the end of 1955 the total assets of those funds amounted to \$7.8 billion. By the end of 1965 they stood at \$35.2 billion, four and one-half times the 1955 figure. Capital inflow from "net shares issued" (shares issued less shares redeemed) accounted for approximately 65 percent of this asset growth. During 1965 net assets grew by \$6.1 billion from \$29.1 billion at the end of 1964. Approximately \$3.2 billion of that gain—53 percent—came from net shares issued.

<sup>4</sup> Sec. 2(a)(31).

<sup>5</sup> Barron's, Jan. 10, 1966, p. 11.

<sup>6</sup> As of June 30, 1965, ICI members held 93 percent of all mutual fund assets.

**TABLE V-1. — Relationship of mutual fund assets, new shares issued, and shares redeemed, 1955-65**

[Dollar amounts in millions]

| Year         | Total net assets | New shares issued <sup>a</sup> |  |           | Total shares redeemed <sup>a</sup> | Net new shares issued <sup>a</sup> | Total shares redeemed as a percent of new shares issued | New shares issued <sup>b</sup> if capital gains and the investment of income dividends as a percent of shares redeemed | Shares redeemed as a percent of total net assets |
|--------------|------------------|--------------------------------|--|-----------|------------------------------------|------------------------------------|---|--|--|
|              |                  | Sales <sup>b</sup>             | Reinvestment of capital gains distributions and investment | Total     |                                    |                                    |   |  |  |
| 1955.....    | \$7,837.5        | ( <sup>c</sup> )               | ( <sup>c</sup> )   | \$1,226.3 | \$442.6                            | \$783.7                            | 36.1  | ( <sup>c</sup> )   | 5.6  |
| 1956.....    | 9,046.4          | ( <sup>c</sup> )               | ( <sup>c</sup> )   | 1,534.4   | 432.8                              | 1,101.6                            | 28.2  | ( <sup>c</sup> )   | 4.8  |
| 1957.....    | 8,714.1          | \$1,284.8                      | \$271.6  | 1,556.4   | 405.7                              | 1,150.7                            | 26.1  | 66.9   | 4.7  |
| 1958.....    | 13,242.4         | 1,535.4                        | 275.9  | 1,811.3   | 511.3                              | 1,300.0                            | 28.2  | 54.0   | 3.9  |
| 1959.....    | 15,818.0         | 2,162.3                        | 439.7  | 2,602.0   | 785.6                              | 1,816.4                            | 30.2  | 56.0   | 5.0  |
| 1960.....    | 17,025.7         | 1,978.6                        | 431.8  | 2,410.4   | 841.8                              | 1,568.6                            | 34.9  | 51.3   | 4.9  |
| 1961.....    | 22,788.8         | 2,768.6                        | 568.2  | 3,336.8   | 1,160.4                            | 2,176.4                            | 34.8  | 49.0   | 5.1  |
| 1962.....    | 21,270.7         | 2,522.5                        | 669.2  | 3,191.7   | 1,122.7                            | 2,069.0                            | 35.2  | 59.6   | 5.3  |
| 1963.....    | 25,214.4         | 2,202.1                        | 675.4  | 2,877.5   | 1,505.3                            | 1,372.2                            | 52.3  | 44.9   | 6.0  |
| 1964.....    | 29,116.3         | 3,117.1                        | 899.1  | 4,016.2   | 1,874.1                            | 2,142.1                            | 46.7  | 48.0   | 6.4  |
| 1965.....    | 35,220.2         | 4,009.8                        | 1,186.8  | 5,196.6   | 1,962.4                            | 3,234.2                            | 37.8  | 60.5   | 5.6  |
| 1955-65..... |                  |                                |  | 29,759.6  | 11,044.7                           | 18,714.9                           | 37.1  |  |  |

<sup>a</sup> Net asset value at time of issuance or redemption.

<sup>b</sup> Includes regular single purchase sales, voluntary accumulation plan sales, contractual plan sales, conversions, and some miscellaneous share issuances.

<sup>c</sup> Not available.

Source: Investment Company Institute.

Total capital outflow through redemptions has been consistently less than capital inflow through sales of new shares and through investment of dividend income and capital gains distributions. For the 1955-1965 period, capital outflow amounted to only 37.1 percent of capital inflow through the issuance of new shares. Even in 1963, the year in which sales of new fund shares experienced the most marked decline of the period, the dollar outflow from redemptions was only 52.3 percent of dollar inflow from the issuance of new shares.

Table V-1 indicates that, apart from sales of new fund shares, inflow from investments of dividend income and reinvestments of capital gains distributions reduced a substantial portion of the outflow attributable to redemptions of outstanding shares. For the years 1957 through 1965 the value of shares so issued amounted to 53.3 percent of the value of shares redeemed, ranging from 44.9 percent in 1963 to 66.9 percent of such outflow in 1957. In 1965 investments of distributed dividend income and reinvestment of distributed capital gains amounted to 60.5 percent of redemptions.

### C. MUTUAL FUND SALES LOADS

Some mutual funds—the so-called “no-load funds”—sell their shares at net asset value without the imposition of a sales load. No-load funds, however, account for only a small share of total mutual fund assets and shareholder accounts.<sup>7</sup> The overwhelming majority of mutual fund shareholders invest in “load” funds.

#### 1. *The basic load*

The purchase price of a load fund share consists of two elements—its net asset value and a sales load.<sup>8</sup> The sales load is by far the most significant charge paid by mutual fund investors. Rarely is the basic load less than 7.5 percent of the total price that the investor pays and it has not exceeded 9 percent.

An 8.5 percent sales load is most common. Of the 195 load funds listed in one mutual fund compilation, only 8 charge less than 7.5 percent. One of those eight funds, which charges 4 percent, is unavailable to the general public. Another, which charges 4.15 percent, is a bond fund. In only 25 cases are the loads between 7.5 percent and 7.99 percent. In another 34 cases the loads are from 8.0 percent to 8.49 percent. But 128, or about two-thirds of those 195 funds, charge 8.5 percent or more. More than half of the funds (102 of the 195) charge exactly 8.5 percent, and an additional 26 charge higher loads.<sup>9</sup>

The payment of the sales load generally entitles the investor to retain his shares indefinitely, to assign them and to bequeath them to his heirs. However, two funds—the \$1.1 billion Insurance Securi-

<sup>7</sup> As of June 30, 1966, the approximately 60 no-load funds registered with the Commission held assets of \$2.1 billion, less than 5 percent of total mutual fund assets on that date. See pp. 51-52, *supra*.

<sup>8</sup> The per share net asset value of a mutual fund is calculated by dividing the fund's total net assets by the number of shares currently outstanding. This calculation is usually made—and if the fund's shares are sold by members of the National Association of Securities Dealers, Inc. (“NASD”), it must be made—twice daily if transactions are effected on the basis of a net asset value determined prior to receipt of the order (“backward pricing”). If transactions are effected on the basis of the next calculation after receipt of the order (“forward pricing”), then net asset value need be calculated only once daily. See NASD Rules of Fair Practice, secs. 26(e) and 26(h), NASD Manual D-16 and D-18.

<sup>9</sup> Arthur Wiesenberger & Co., *Mutual Fund Charts and Statistics, 1966*. The 10 largest mutual funds charge sales loads typical of the general industry pattern. None of these funds charges less than 7.5 percent. Indeed, only one charges a load as low as 7.5 percent. Two charge an 8 percent load. A fourth charges an 8.375 percent load. Four of the remaining six charge 8.5 percent, and two charge more. One charges an 8.75 percent load and the other an 8.85 percent load.

ties Trust Fund and the \$35.3 million Commonwealth Fund Indenture of Trust Plan A and Plan B <sup>10</sup>—issue certificates which mature, respectively, at the end of 10 years and of 21 years or the life of the purchaser, whichever is longer.

Investors who wish to retain their interests in these two funds after their certificates have expired must purchase new certificates. When they do so, they are charged another full sales load of 8.85 percent in the case of Insurance Securities Trust Fund and 7.65 percent in that of Commonwealth.<sup>11</sup>

As noted in chapter II, mutual fund sales loads are described in the Act and are calculated as a percentage of the total purchase price.<sup>12</sup> This differs from the way of expressing sales commissions or markups in exchange or over-the-counter securities transactions, i.e., as a percentage of the net amount actually invested.<sup>13</sup> For example, if the current net asset value of a fund's shares is \$9.15 per share and the sales load is 8.5 percent, the public offering price to investors will be \$10 per share. The \$0.85 per share sales load is 8.5 percent of the public offering price but represents a markup of 9.3 percent on the \$9.15 per share actually put to work for the investor in the fund:

Acquiring an interest in a mutual fund portfolio entails additional costs to investors. The brokerage costs which are paid by fund shareholders when a fund sells and buys portfolio securities are a necessary incident of having a professionally managed securities portfolio. These added brokerage costs raise the real costs of mutual fund investing to substantially in excess of the 9.3 percent sales charge which the typical sales load represents. Assuming that the funds pay portfolio brokerage at rates averaging the 1 percent New York Stock Exchange minimum, the cost of investing in load fund shares is close to 10 percent.<sup>14</sup>

The purchases and sales by a fund of its portfolio securities are occasioned in some cases by the injections of new capital into and the withdrawals of old capital from a mutual fund, and in other cases by the decision of the fund manager that the market price of a security warrants a purchase or sale, irrespective of the fund's cash position. In either case, the fund shareholder pays the brokerage costs.

## 2. Quantity discounts

Most funds reduce the basic load when a large investment is made. The extent of these quantity discounts varies considerably from fund to fund. Usually the point at which the load is reduced, the so-called first breakpoint, is within the \$10,000 to \$25,000 range. The reduced load applies to the entire purchase and not merely to that portion in excess of the breakpoint.

Nineteen of the twenty largest mutual funds as of June 30, 1965, had reduced sales loads for quantity purchases of their shares.<sup>15</sup> Six of the twenty funds charge reduced loads on purchases of \$25,000

<sup>10</sup> Asset figures in both cases are as of June 30, 1966.

<sup>11</sup> Commonwealth certificateholders have another option. Within certain time limits, they may exchange their certificates for those of Commonwealth Fund Indenture of Trust, Plan C by paying a 4 percent load.

<sup>12</sup> Sec. 2(a)(34), and see pp. 52-53, *supra*.

<sup>13</sup> Underwriting commissions and discounts with respect to the sale of conventional newly issued or outstanding securities being offered for the first time are computed in the same fashion as mutual fund sales loads, i.e., as a percentage of the total purchase price. The distribution of conventional securities of this sort differs, however, in a number of significant respects from the distribution of mutual fund shares. See pp. 54-55, *supra*, and pp. 212-213, *infra*.

<sup>14</sup> Such brokerage also is present in no-load funds.

<sup>15</sup> The other, Insurance Securities Trust Fund, charges the same 8.85 percent load regardless of the size of the purchase.

or over, and the reduction in the load at that point averages almost 2.5 percent of the public offering price. At the other extreme, three funds reduce sales loads starting with purchases of \$5,000. However, the reduction in the sales load at that level is 0.50 percent of the offering price for two of the funds and 0.75 percent for the third. Of the other 10 funds, 4 have reduced loads for purchases of \$10,000, 2 for purchases of \$12,500, and 4 for purchases of \$15,000.

Reduced sales loads for quantity purchases of mutual fund shares are frequently available for a combined investment in two or more funds managed by the same adviser-underwriter. For example, under a schedule which provides a breakpoint for a \$25,000 purchase, an investor who places \$15,000 in an adviser-underwriter's common stock fund and \$10,000 in its balanced fund benefits from the breakpoint to the same extent as if he had placed his entire \$25,000 in only one of the adviser-underwriter's funds.

Separate purchases made by a single investor within a 13-month period are almost always viewed as a single transaction entitling the purchaser to a quantity discount.<sup>16</sup> But this is so only if the investor has signed a letter stating that he intends to invest a specified amount within the prescribed period.<sup>17</sup> The initial investment made pursuant to such a statement is subject to the load normally applicable to purchases of that amount. However, as soon as the investor's aggregate purchases during the 13-month period reach an amount that qualifies for a quantity discount, the load on his last purchase is sufficiently reduced to give him the benefit of the discount with respect to all his purchases during the period. For example, if a fund charges a basic load of 8.5 percent which falls to 7.5 percent on letter of intention purchases of \$15,000 or more, an investor who makes three separate \$5,000 purchases within a 13-month period pays a load of \$425 (8.5 percent) on each of his first two purchases. However, on his third \$5,000 purchase the load drops to \$275 (5.5 percent of \$5,000) for a total loading charge of \$1,125, the exact amount that would have been charged on a lump-sum purchase of \$15,000.<sup>18</sup>

The reduced loads charged on substantial purchases of fund shares benefit some investors. For a few very large investors the reductions can be substantial. However, the relatively slight reductions available at the initial breakpoints are far beyond the reach of most investors. Almost two-thirds of all regular mutual fund account holders<sup>19</sup> had fund shares valued at less than \$10,000 in 1966.<sup>20</sup>

The size of the group that benefits from breakpoints cannot be measured by the current market value of holdings. One must look to the amounts of purchases made. The median dollar amount of a

<sup>16</sup> Rule 22d-1(a) under the Act (17 C. F. R. 270.22d-1(a)) permits: (1) quantity discounts and (2) the extension of such discounts to a group of purchases by a single investor. Whether a particular fund elects to give discounts for quantity purchases and whether groups of purchases are viewed as single transactions for the purpose of such discounts are questions which have been left to the fund managers.

<sup>17</sup> See Rule 22d-1(a), cited in the preceding footnote.

<sup>18</sup> In addition, some funds give reductions in sales loads over an unlimited period to investors who make repeated purchases of their shares. Under these arrangements the reduced sales load applies not to the entire amount of the investor's purchases but only to those purchases made after the breakpoint has been reached. In some such plans the availability of the breakpoint depends on the aggregate amount that the investor paid for the shares previously acquired; in others it turns on the current value of those shares.

<sup>19</sup> This refers to shareholders who do not have accumulation plan accounts. Accumulation plan accounts are discussed at pp. 223-250, *infra*.

<sup>20</sup> This statement and those that follow are based on a sampling of the mutual fund shareholder population by the Investment Company Institute in 1966. The Institute's study found that 64.2 percent of the investors surveyed held fund shares with a market value of less than \$10,000. See also Special Study, pt. 4, 279.

purchase of mutual fund shares was only \$1,240.<sup>21</sup> The median most recent purchase of those whose fund shares were valued at from \$10,000 to \$25,000 was only \$1,900 and only one-seventh of such shareholders expended \$10,000 or more on their most recent purchase.<sup>22</sup> Even among shareholders who had fund shares valued at more than \$25,000 the median most recent purchase amounted to \$4,825, and only 28.2 percent of this small group spent as much as \$10,000 on their most recent purchase of fund shares.

Moreover, a majority of fund investors hold shares in more than one fund. Since multifund investments are especially widespread among those who have placed substantial sums in the funds,<sup>23</sup> the tendency to invest in a number of funds further narrows the size of the already limited class that benefits from the existence of the breakpoints. As previously noted, purchases of shares in two or more funds cannot be added together for breakpoint purposes unless all of the funds involved have a common adviser-underwriter.<sup>24</sup>

### 3. Allocation of sales loads

No part of the sales load goes to the fund for investment on behalf of shareholders.<sup>25</sup> Instead, sales loads are divided among principal underwriters, retail dealers, and persons associated with such underwriters and dealers.<sup>26</sup> Principal underwriters usually retain from 0.50 percent to 2.5 percent of the offering price (2 percent is most typical) and allot from 6 to 8 percent as the dealer concession. At present, the most typical dealer concession is 6.5 percent of the purchase price.

The salesman's share varies from dealer to dealer. Typically, mutual fund salesmen receive at least half of the 6 to 8 percent dealer concession. Some dealers pay salesmen the same commission, such as 3 percent of the offering price, on sales of all fund shares, regardless of variations in dealer concessions and fund brokerage commissions paid on such sales. Others key sales compensation to a percentage of the dealer concession.<sup>27</sup>

Some principal underwriters maintain direct retail sales organizations of their own. These direct retail sales organizations, sometimes referred to by the industry as "captive sales forces," are formed for the primary purpose of selling the shares of the specific fund or group of funds for which the organization acts as adviser-underwriter.<sup>28</sup> Although captive sales organizations make a concentrated effort to sell shares of these funds, many sell the shares of other funds as well. However, these organizations pay higher commissions on sales of

<sup>21</sup> The Investment Company Institute's sampling also showed that the dollar amount of the most recent purchase of investment company shares was below \$5,000 in 83.3 percent of the cases surveyed and above \$10,000 in only 7.3 percent of those cases.

<sup>22</sup> The Institute found that 21.4 percent of the fund shareholder population had holdings valued at from \$10,000 to \$25,000 and that an additional 14.4 percent had holdings valued at \$25,000 and over.

<sup>23</sup> The Institute found that 93.1 percent of those shareholders with \$25,000 or more in mutual fund holdings owned shares in more than one fund and that 77.8 percent of that group held shares in three or more funds.

<sup>24</sup> See p. 206, *supra*. The absence of data as to the number of multifund investors who have investments in funds belonging to different complexes makes it impossible to quantify the extent of this further narrowing.

<sup>25</sup> Many fund investors appear to be under misapprehensions about this point. More than 30 percent of the mutual fund investors who responded to a survey conducted by the Wharton School did not know whether sales charges paid by new investors contributed to earnings of their mutual funds, and a significant proportion (22 percent of regular purchasers and 36 percent of contractual plan investors) thought that they did. *Special Study*, pt. 4, 316.

<sup>26</sup> A few no-load funds impose relatively low sales charges that go to the funds themselves. See note 124 *on p. 52*, *supra*.

<sup>27</sup> Salesmen seldom receive a percentage of the brokerage commissions paid to their employers as extra compensation for sales of fund shares, but such commissions may be an important factor in setting their rates of compensation on the shares of different funds.

<sup>28</sup> Funds that are exclusively or primarily distributed by a dozen captive sales forces hold over 40 percent of all mutual fund assets.

shares of the funds they manage than for sales of other fund shares.<sup>29</sup> Independent broker-dealers also may seek to concentrate their selling efforts on shares of selected funds by varying salesmen's commissions for sales of the shares of different funds.

#### 4. Competitive pressures on sales loads and dealer concessions

Differences in the compensation paid to retail sellers of fund shares play a most important part in the competition for sales. During the past 16 years, competition for dealer favor has exerted significant upward pressures on the general level of mutual fund sales loads and, to an even greater extent, on the level of the dealer concession.

Changes in sales loads and dealer concessions from 1950 to 1966 are shown in table V-2. That table lists 30 of the largest funds as of the end of 1950. From 1950 to 1966, 13 of the 30 funds increased their sales loads. In 1950, half of them charged a load of 7.5 percent or less and only 7 of the 30 charged 8.5 percent or more. By 1966, these ratios were approximately reversed—only 7 of the 30 funds had sales loads of 7.5 percent or less, while 18 charged 8.5 percent or more.

TABLE V-2.—Basic sales loads and dealer concessions of 30 mutual funds,<sup>a</sup> 1950 versus 1966

|  | Sales load <sup>b</sup> |      | Dealer concession <sup>b</sup> |                  | Percent increase in— |                   |
|--|-------------------------|------|--------------------------------|------------------|----------------------|-------------------|
|  | 1950                    | 1966 | 1950                           | 1966             | Sales load           | Dealer concession |
| 1. Affiliated Fund, Inc. ....                      | 7.50                    | 7.50 | 6.00                           | 6.00             | -----                | -----             |
| 2. ....  | 7.50                    | 7.50 | 6.00                           | 6.00             | -----                | -----             |
| 3. ....  | 8.00                    | 8.50 | 6.00                           | 7.00             | 6.3                  | 16.7              |
| 4. ....  | 8.00                    | 8.00 | 6.00                           | 6.00             | -----                | -----             |
| 5. Century Shares Trust <sup>c</sup> .....         | 7.00                    | 8.50 | 4.00                           | 6.00             | 21.4                 | 50.0              |
| 6. Chemical Fund, Inc. ....                        | 7.50                    | 8.50 | 5.00                           | 6.50             | 13.3                 | 30.0              |
| 7. Colonial Growth & Energy Shares, Inc. ....      | 7.50                    | 8.50 | 5.00                           | 6.50             | 13.3                 | 30.0              |
| 8. Commonwealth Investment Co. ....                | 8.00                    | 8.50 | 6.00                           | 7.00             | -6.3                 | 16.7              |
| 9. Delaware Fund, Inc. ....                        | 8.50                    | 8.50 | 6.00                           | 6.00             | -----                | -----             |
| 10. Dividend Shares, Inc. ....                     | 8.67                    | 8.67 | 6.00                           | 6.00             | -----                | -----             |
| 11. Eaton & Howard Balanced Fund .....             | 6.00                    | 7.50 | 4.50                           | 6.38             | 25.0                 | 41.8              |
| 12. Equity Fund, Inc. ....                         | 3.50                    | 3.50 | 2.62                           | ( <sup>d</sup> ) | -----                | ( <sup>d</sup> )  |
| 13. Fidelity Fund, Inc. ....                       | 7.50                    | 7.50 | 6.00                           | 6.00             | -----                | -----             |
| 14. Financial Industrial Fund, Inc. ....           | 8.50                    | 8.50 | 6.53                           | 7.00             | -----                | 26.6              |
| 15. Fundamental Investors, Inc. ....               | 8.75                    | 8.75 | 6.00                           | 7.00             | -----                | 16.7              |
| 16. Group Securities, Inc. ....                    | 8.50                    | 8.50 | 6.00                           | 6.00             | -----                | -----             |
| 17. Investment Co. of America .....                | 8.00                    | 8.50 | 6.00                           | 7.00             | 6.3                  | 16.7              |
| 18. Investors Mutual, Inc. ....                    | 7.50                    | 8.00 | ( <sup>e</sup> )               | ( <sup>f</sup> ) | 6.7                  | ( <sup>f</sup> )  |
| 19. Keystone Custodian Funds <sup>g</sup> .....    | 8.30                    | 8.30 | 5.00                           | 6.00             | -----                | 20.0              |
| 20. Knickerbocker Fund .....                       | 8.70                    | 8.70 | 6.00                           | 6.50             | -----                | 8.3               |
| 21. Massachusetts Investors Trust .....            | 7.50                    | 8.50 | 5.00                           | 6.00             | 13.3                 | 20.0              |
| 22. Massachusetts Life Fund .....                  | 7.00                    | 8.50 | 5.00                           | 6.50             | 21.4                 | 30.6              |
| 23. National Investors Corp. ....                  | 7.50                    | 7.50 | 5.00                           | 6.00             | -----                | 20.0              |
| 24. National Securities Series .....               | 8.50                    | 8.50 | 6.00                           | 6.00             | -----                | -----             |
| 25. The George Putnam <sup>h</sup> of Boston ..... | 7.00                    | 8.50 | 5.00                           | 6.25             | 21.4                 | 25.0              |
| 26. Putnam Investors Fund, Inc. <sup>i</sup> ..... | 7.50                    | 8.50 | 5.00                           | 6.25             | 13.3                 | 25.0              |
| 27. ....   | 7.50                    | 7.50 | 6.00                           | 6.00             | -----                | -----             |
| 28. Television-Electronics Fund, Inc. ....         | 8.25                    | 8.25 | 5.50                           | 7.00             | -----                | 27.3              |
| 29. United Income Fund .....                       | 8.00                    | 8.50 | 6.00                           | 6.00             | 6.3                  | -----             |
| 30. Wellington Fund, Inc. ....                     | 8.00                    | 8.00 | 5.00                           | 6.00             | -----                | 20.0              |

<sup>a</sup> Includes load funds with yearend 1950 net assets of over \$5,000,000 which have not since merged into another mutual fund. Where more than one such fund was underwritten by a common principal underwriter, only the one which had the greatest net assets at the end of 1950 has been included.

<sup>b</sup> Expressed as a percentage of public offering price.

<sup>c</sup> Although its present principal underwriter, Vance, Sanders & Co., also underwrites Massachusetts Investors Trust, in 1950 Century Shares Trust had a different principal underwriter, Century Distributors.

<sup>d</sup> No longer distributed through dealers.

<sup>e</sup> Although its present principal underwriter, Putnam Fund Distributors, Inc., also underwrites The George Putnam Fund of Boston, until 1964 Putnam Investors Fund, Inc., had another principal underwriter and was known until 1966 as Incorporated Investors.

<sup>f</sup> Distributed exclusively through the principal underwriter's own retail sales organization.

<sup>29</sup> For example, one such organization paid its salesmen two-thirds of the dealer discount (including an 8.33 percent contribution to its profit-sharing plan) for sales of fund shares managed by its affiliate but only one-half of the dealer discount on sales of other fund shares. Special Study, pt. 4, 124.

The table also shows significant increases in the dealer concessions. Principal underwriters for 18 of the 28 funds that distributed shares at least partly through independent dealers in 1966 had increased dealer concessions over those paid in 1950.<sup>30</sup> Eleven of the 18 funds' underwriters had also increased the sales load since 1950, and 10 of the 11 had raised dealer concessions by at least the amount of the increase in sales load.<sup>31</sup>

Seven of the ten underwriters increased dealer concessions even more by retaining a smaller portion of the sales load for themselves in 1966 than they had retained in 1950.<sup>32</sup> Another seven that did not raise their sales loads also increased their dealer concessions, thus reducing their own share of the unchanged load. In both 1950 and 1966, 15 of the 28 funds had dealer concessions of 6 percent. However, in 1950 a 6 percent dealer concession was the maximum, and the dealer concessions of the remaining 13 funds ranged from 4 to 5.53 percent. In 1966 a 6 percent dealer concession was the minimum, and dealer concessions of the remaining 13 funds ranged from 6.25 to 7 percent.

Thus, competition among the fund's principal underwriters has raised rather than lowered costs. Faced with the choice of appealing to price-conscious investors or to compensation-conscious fund retailers, most load fund underwriters have followed the latter course.<sup>33</sup> As has been noted in chapter III, the mutual fund underwriting function is often unprofitable even to underwriters of the largest funds and fund complexes and is seldom as profitable as the advisory function.<sup>34</sup> Maintenance of relatively unprofitable underwriting operation, in some instances, reflects business decisions of fund managers to subsidize selling efforts in the hope of generating increases in advisory and brokerage revenues through sales of new shares.

#### D. COMPARISON OF MUTUAL FUND SALES LOADS WITH COSTS OF OTHER SECURITIES TRANSACTIONS

##### 1. Comparison with exchange commission rates

The purchaser of securities issued by most mutual funds invests in a portfolio consisting mainly of equity securities listed on the New York Stock Exchange. Brokerage commission rates for round lot transactions (usually 100 shares or multiples thereof) on that exchange and on other national securities exchanges vary with the price of the security involved. For round lot transactions in stocks priced at \$40 per share the exchange commission amounts to 1 percent of the dollar amount involved.<sup>35</sup> An additional charge, the odd lot differential, is imposed on orders or any portion of any order involving less than a round lot.<sup>36</sup>

<sup>30</sup> The two funds that in 1966 did not distribute shares through independent dealers were Equity Fund, Inc. (whose shares, though sold by some independent dealers in 1950, appear to have been sold exclusively in 1966 through its principal underwriter) and Investors Mutual, Inc. (whose shares have always been distributed exclusively through its adviser-underwriter's captive sales organization).

<sup>31</sup> The 11th fund, the George Putnam Fund of Boston, raised its sales load from 7 percent to 8.6 percent and its dealer concession from 6 percent to 6.25 percent.

<sup>32</sup> For example, in 1950 the offering price of shares of Chemical Fund, Inc., included a 7.5 percent sales load—the principal underwriter's portion was 2.6 percent and the dealer's 5 percent. In 1966 that fund's sales load was 8.6 percent—the principal underwriter's portion was 2 percent and the dealer concession 6.5 percent.

<sup>33</sup> This seems to have been as true in the pre-ACT period as it has been in more recent years. See Investment Trust Study, pt. 3, 310-312 for an account of Massachusetts Investors Trust's experience with experiments in lower sales loads.

<sup>34</sup> See pp. 122-123, *supra*.

<sup>35</sup> The average price of shares traded on the NYSE in 1965 was \$40.50. NYSE Fact Book, 1966. Commission rates are somewhat higher for round lot orders in securities priced at less than \$40 and slightly lower for securities priced above \$40 per share.

<sup>36</sup> The odd lot differential is  $\frac{1}{4}$  of a point (12.5 cents) per share for stocks priced at less than \$55 and  $\frac{1}{4}$  of a point (25 cents) for stocks priced at \$55 or more.

TABLE V-3.—Comparison of sales charges for acquiring and disposing of stocks traded at \$40 per share on the New York Stock Exchange with sales charges for an equal amount invested in mutual fund shares

| Value of shares acquired | NYSE commission and odd lot differential (on orders of less than 100 shares) as percentage of amount invested <sup>a</sup> |            | Mutual fund acquisition cost <sup>b</sup> (expressed as percentage of net asset value of shares received) | Mutual fund acquisition costs as a percentage of NYSE round trip commissions |
|--------------------------|--|------------|---|--|
|                          | Purchase   | Round trip |   |  |
| \$200                    | 3.3  | 6.6        | 9.3   | 140  |
| 600                      | 2.2  | 4.3        | 9.3   | 216  |
| <sup>c</sup> 1,120       | 1.8  | 3.5        | 9.3   | 264  |
| 2,600                    | 1.5  | 2.0        | 9.3   | 317  |
| 4,000                    | 1.0  | 2.0        | 9.3   | 376  |
| 16,000                   | 1.0  | 2.0        | 8.1   | 416  |
| 28,000                   | 1.0  | 2.0        | 6.1   | 313  |
| 52,000                   | 1.0  | 2.0        | 4.2   | 214  |
| 100,000                  | 1.0  | 2.0        | 3.4   | 172  |
| 260,000                  | 1.0  | 2.0        | 2.6   | 131  |
| 1,000,000                | 1.0  | 2.0        | 1.0   | 51   |

<sup>a</sup> Assumes sale at same price as purchase price (excluding odd lot differential).  
<sup>b</sup> Based on the following schedules of sales loads for shares of Massachusetts Investors Trust, like virtually all load funds, imposes no redemption charge:

|                                     | Sales load     | Sales charge (as a percent of net asset value of shares received) |
|-------------------------------------|----------------|---|
|                                     | <i>Percent</i> |   |
| Less than \$12,500.....             | 8.50           | 9.29  |
| \$12,500 to under \$25,000.....     | 7.50           | 8.11  |
| \$25,000 to under \$50,000.....     | 5.75           | 6.10  |
| \$50,000 to under \$100,000.....    | 4.00           | 4.17  |
| \$100,000 to under \$250,000.....   | 3.25           | 3.36  |
| \$250,000 to under \$1,000,000..... | 2.50           | 2.56  |
| \$1,000,000 and over.....           | 1.00           | 1.01  |

<sup>c</sup> The median purchase of \$1,240 reported in the Investment Company Institute's 1966 survey of mutual fund shareholders, after deduction of the typical 8.5 percent sales load, would have resulted in an acquisition of shares valued at \$1,135.

Table V-3 compares the brokerage commissions for buying and selling on an exchange various amounts of securities priced at \$40 per share both at the time of purchase and of sale<sup>37</sup> with sales charges for investments of the same amounts through fund shares issued by Massachusetts Investors Trust, the second largest mutual fund.<sup>38</sup> Its sales charges are considered representative of the fund industry generally.<sup>39</sup> Since shares of virtually all load funds are redeemed without separate charge, mutual fund sales charges are compared with the total cost of buying and selling a security on an exchange ("round-trip cost").<sup>40</sup>

<sup>37</sup> If the security depreciates in price between the time of purchase and subsequent sale, the dollar amount of the commission charge for the sale of the security falls. Conversely, if the security appreciates between the purchase and sale, the amount of the commission charged for the sale rises.

<sup>38</sup> Although shares of this fund and of most others usually are priced at substantially less than \$40, their portfolios consist in the main of securities that are higher priced than the fund shares themselves. (Most funds try to keep the per share prices of their shares down to fairly low levels.)

<sup>39</sup> Basic sales loads generally vary from 7.5 to 8.85 percent of the offering price and cluster around 8.5 percent. See pp. 204-205, supra. Reductions from basic sales loads for large purchases vary considerably more, both in the extent of the reductions and in the breakpoints at which they become effective.

<sup>40</sup> In comparing mutual fund sales loads with the round-trip costs of investing in an exchange listed security, it should be noted that while the entire mutual fund sales load is paid at the time of purchase, in an exchange transaction the investor has full use of one-half the round-trip brokerage commission until the time of sale. Moreover, the comparison does not take into account the added brokerage expenses from sales and redemptions of fund shares. See P. 205, supra.

Table V-3 shows that for \$200 invested in mutual fund shares the typical 9.3 percent basic sales charge<sup>41</sup> amounts to 40 percent more than the 6.6 percent round-trip cost of buying and selling shares in the exchange markets. For a \$1,120 investment, an amount just below the median net mutual fund purchase,<sup>42</sup> the typical 9.3 percent mutual fund sales charge is more than 2½ times the round-trip exchange brokerage cost of 3.5 percent. Between \$1,120 and the round lot amount (\$4,000 in this example) the disparity increases markedly to the point where the sales charge on \$4,000 invested is over 4¾ times the round-trip exchange commission. The increased disparity reflects the fact that mutual fund sales loads remain constant until the first breakpoint (\$12,500 in this example) is reached, while exchange commission rates drop progressively until 100 share round-lot orders are reached—at which point they amount to a 2 percent round-trip commission on a \$4,000 investment—and remain constant for larger round lot orders.

At the first breakpoint, MIT's reduced mutual fund sales charge of 8.1 percent on \$16,000 invested is still more than four times the round-trip commission on an exchange transaction of this amount. For \$28,000 and \$52,000 investments in MIT shares, an investor pays sales charges of 6.1 percent and 4.2 percent, respectively, more than triple and double the costs of buying and selling similar amounts of a \$40 security on an exchange. And even when \$260,000 is invested in MIT shares, the sales charges are 31 percent higher than the round-trip commissions on the investment in a \$40 exchange-listed security.

Some funds' sales load schedules provide greater, and others lesser, savings from the basic load than MIT's schedule. However, sales charges in the mutual fund industry almost never are as low as the round-trip cost of transactions on exchanges for investments of less than \$100,000.

The above comparisons understate the disparities between exchange commissions and mutual fund sales charges. First, they omit the brokerage costs borne by the fund shareholders when the fund buys portfolio securities with money received from the sale of new shares. Secondly, in comparing mutual fund sales charges to sales charges for buying and selling other securities, they assume that a mutual fund investor who wishes to sell his shares needs the services of a broker-dealer to find a buyer. This is not so. The mutual funds themselves redeem the shares—without charge in the case of virtually *all* load funds—when investors mail them to the fund. Hence the actual disparities between exchange commission rates and mutual fund sales charges are double those shown in the above comparisons.

## 2. Comparison with costs of over-the-counter transactions

Since commissions and mark-ups in the over-the-counter market are not fixed, the charge for executing the same transaction may vary among different broker-dealers. However, most individuals' over-the-counter transactions in equity securities are effected on an agency

<sup>41</sup> As noted at p. 205, *supra*, the normal load of 8.5 percent of the aggregate purchase price is a 9.3 percent sales charge when expressed as a percentage of the purchaser's actual net investment in the fund.

<sup>42</sup> The median mutual fund purchase of \$1,240 noted at pp. 206-207, *supra*, represents an investment of about \$1,135 in the fund's portfolio after an 8.5 sales load is deducted.

basis.<sup>43</sup> In the overwhelming majority of such agency transactions, the brokerage commission is no higher than the exchange commission would be.

In the minority of individuals' over-the-counter transactions the dealer acts as principal rather than as agent. The sales charges in such transactions are usually, though not always, somewhat higher than if effected on an agency basis, but nevertheless substantially less than the basic mutual fund sales load.

The recent Booz-Allen study prepared for the NASD examined over-the-counter sales charges in September 1965. It found that the *weighted* average sales charge on investors' purchases of over-the-counter stocks was 1.4 percent. That study also showed that the *weighted* average sales charge when investors sold over-the-counter stocks was 1.0 percent.<sup>44</sup> (The weighted average gives greater force to large transactions; thus the charge on a \$100,000 transaction is counted equally with the sum of the charges on 100 transactions of \$1,000 each.) A survey by the Investment Company Institute of funds whose total assets were about 50 percent of the industry in 1965 showed that the *weighted* average sales load, similarly calculated, was 5.5 percent (or 5.8 percent when expressed as a sales charge).<sup>45</sup>

In view of the substantial disparity that exists between the average sales charges in over-the-counter transactions and mutual fund sales charges, it is noteworthy that the Booz-Allen study reported:

The partners of numerous local firms in the five cities visited during the course of this study \* \* \* pointed out that their salesmen typically had to work much harder to sell over-the-counter stocks than mutual fund shares \* \* \*.<sup>46</sup>

### 3. Comparison with underwriters' spreads

Sales charges in the securities business tend to be highest in underwritten public offerings of equity securities distributed through underwriters either on a firm commitment or best efforts basis. These charges are referred to as underwriters' spreads.

Conventional underwritings involve the distribution of substantial blocks of securities within fixed and extremely limited time periods. The major portion of underwriting spreads is devoted to compensating members of underwriting groups for the intensive promotional and

<sup>43</sup> A survey conducted in 1962 by the Special Study showed that 64 percent of individuals' over-the-counter purchases and 78 percent of their sales were effected on an agency basis. The balances were effected on a principal basis. The Special Study found that, unlike the commissions charged in agency transactions, the markups on transactions effected on a principal basis were usually greater than a stock exchange commission and that markups charged in riskless principal transactions were greater than those in principal transactions in which the dealer had the securities in inventory and thus was at risk. Special Study, pt. 2, 612-613, 625-626.

<sup>44</sup> Statistics in the recent Booz-Allen study prepared for the NASD (see pp. 181, 186 *supra*) suggests that in 1965 the percentage of individuals' over-the-counter transactions executed on an agency basis was higher than those found by the Special Study in 1962 and that the percentage of individuals' transactions executed on a riskless principal basis declined. See Booz-Allen study 15.

<sup>45</sup> Booz-Allen study 34-35.  
A narrower study by the Commission's staff early in 1964 surveyed the pricing practices of small retail over-the-counter broker-dealers, none of which were located in the 15 largest cities in the United States. Even among such small firms—which account for a very small percentage of over-the-counter trades—sales charges in over-the-counter transactions were substantially below the typical 9.3 percent mutual fund sales charge. The survey found that over one-third of these firms' riskless sales to customers were effected on an agency basis and that on riskless principal sales their median markup was 4.1 percent. These dealers acted as agent in over three-fourths of customers' sales effected on a riskless basis, and as to customers' sales effected on a riskless principal basis the median markdown was 1.2 percent.

<sup>46</sup> Source: Investment Company Institute.

<sup>46</sup> Booz-Allen study 56.

selling efforts required. Often the securities are being offered to the public for the first time, and the underwriters have to arouse investor interest in an unknown security. Even where the underwritten security is already known to the investing public, the underwriters must dispose of a block of securities which is extremely large in relation to normal trading volume within a relatively short period and in a manner which does not significantly depress the price in the trading markets. Toward this end they may risk their capital in attempting to stabilize the market price of the shares during the distribution.

Underwriters also assume other risks. Not the least among these are reputation risks. If the post-distribution performance of the underwritten security is poor, the underwriters may lose customers. Underwriting group members run the risk that if they are unable to sell their allotment of shares, they may not be asked to join in subsequent underwritings.

Moreover, in firm commitment underwritings the underwriters are obligated to buy and to pay for the underwritten securities on a specified date, regardless of whether they are able to complete the distribution by that date. If the entire issue is not sold within the time limit, the underwriters must invest their own capital in the issue—sometimes for a considerable period. And if, subsequent to the termination of the underwritten distribution, they ultimately sell a portion of the issue at prices below those paid to the issuer, they may suffer a loss on the underwriting.

Underwriters do not assume this risk in underwritings conducted on a “best efforts” basis. In these, if the underwriters are unable to complete the distribution, they are not obligated to buy the underwritten securities from the seller. However, best efforts underwritings of conventional securities have little relevance to a comparison of underwriting spreads with mutual fund sales loads. Underwritings of seasoned securities—to which mutual fund shares compare in quality—are almost always on a **firm** commitment basis.

Small portions of underwriting spreads also compensate the investment bankers that manage the underwriting groups for selecting the securities for distribution from the various proposals presented to them, negotiating the terms and conditions of the offering with the sellers, investigating the issuers and organizing underwriting syndicates and selling groups of broker-dealers.

As noted in chapter II, distributions of mutual fund shares are classified for some purposes like conventional underwritings.<sup>47</sup> Those who manage the distribution of fund shares are called “principal underwriters” and, like the spreads in conventional underwritings, mutual fund sales loads are expressed as a percentage of the offering prices rather than as a percentage of the amounts invested. Nevertheless, the distribution of fund shares bears little similarity to conventional underwritten offerings of equity securities.

Mutual fund distributors are not concerned with raising a specific amount of money within a limited time by selling a stated quantity of securities to the public. They continuously sell as many shares of the funds they serve as they possibly can. Although both mutual fund and conventional underwriters bear business risks, mutual fund

<sup>47</sup> See note 126, p. 53, *supra*, and pp. 54-55, 60-61, *supra*.

underwriters assume neither the reputation risks nor the capital risk inherent in conventional firm commitment underwritings. They sell in a price-protected market, since no dealer, whether or not a member of the selling group, may sell shares to the public at less than the current offering price described in the prospectus.<sup>48</sup> And, since the offering price fluctuates as the net asset value of the fund's shares changes and since the fund redeems outstanding shares at current net asset value, the principal underwriter is never called upon to risk its capital in stabilizing the price of a fluctuating security.

Nor does the principal underwriter of a mutual fund bear the expense of selecting securities for distribution and of negotiating the terms and conditions of each offering as does the conventional underwriter. Unlike the underwriting spread, the mutual fund sales load pays only for the continuous promotional efforts of principal underwriters and for the continuous sales efforts of those who retail fund shares to the public.

Despite the foregoing, the amounts paid for the distribution of mutual fund shares—consisting of (a) sales loads paid by purchasers, (b) cash payments from the portfolio brokerage commissions that the funds disburse,<sup>49</sup> and (c) advisory revenues spent in subsidizing the distribution function<sup>50</sup>—are greater, per dollar of investment, than the amounts paid to distribute securities in conventional underwritings. Indeed, even the sales loads are higher than most underwriting spreads. A recent study of underwriting compensation indicates that in recent years average spreads for new issues of equity securities (other than shares of mutual funds, rights offerings and secondary distributions) have ranged from about 4 percent of gross proceeds for common stock issues of over \$10 million to slightly over 10 percent for common stock issues of under \$1 million.<sup>51</sup> The higher spreads for the smaller common stock underwritings reflect the fact that such underwritings generally involve securities issued by smaller and relatively unknown companies. Such securities appeal to a more limited segment of the investing public than mutual fund shares. This study also shows that conventional underwriting spreads decreased significantly from 1940 to 1963.<sup>52</sup>

#### 4. Conclusion

For most investors the sales charges for buying mutual fund shares are considerably higher than charges for buying and selling other types of securities. These higher costs do not pay for and are altogether unrelated to either the professional investment management or the portfolio diversification that the funds supply. No-load funds and closed-end investment companies furnish the same professionally managed, diversified portfolios as load funds do; yet no-load fund shares are available without the sales charges that investors pay when they buy load fund shares, and the sales charges on closed-end shares are those generally applicable to transactions in listed or over-the-counter securities. Managerial expertise and portfolio diversification are paid for by other charges which are of a continuing nature—an

<sup>48</sup> See pp. 218-221, *infra*.

<sup>49</sup> See pp. 162-188, *supra*.

<sup>50</sup> See Wharton report 514-517 and pp. 122-125, *supra*.

<sup>51</sup> Friend, *Investment Banking and the New Issues Market* 69-72 (1965).

<sup>52</sup> *Ibid*. On the other hand, mutual fund sales loads have increased since 1950. For a comparison of salesload levels in 1950 and 1966, see pp. 208-209, *supra*.

annual advisory fee and brokerage commissions. The salesload—paid at the time of purchase—is purely a payment for selling effort.

#### E. SALES LOADS ON INVESTMENTS OF DIVIDEND DISTRIBUTIONS

Many mutual fund shareholders use the dividends and the capital gain distributions that they receive from their funds to acquire additional fund shares through programs for the regular investment of these sums. At the end of 1965, about 58 percent of the estimated 6.7 million mutual fund shareholder accounts provided for the regular investment of dividend income and reinvestment of capital gains distributions. These consisted of accumulation plan accounts—all contractual plans and virtually all voluntary plans<sup>53</sup>—and an estimated one-third of the 4.2 million regular shareholder accounts.<sup>54</sup>

No mutual fund charges a sales load on reinvested capital gains.<sup>55</sup> Contractual plan companies have not been permitted to charge sales loads on invested dividends,<sup>56</sup> and a majority of mutual funds have chosen not to do so. However, a large number of funds—apparently in response to broker-dealer pressure—impose the basic sales load on invested dividends. Of 186 load funds listed in one mutual fund compilation, 78 (43 percent) charged such a load in 1965.<sup>57</sup>

Dividend and capital gains reinvestment plans are administered by the funds' regular stock transfer and dividend disbursing agents and may involve some additional expense. Most funds that do not charge a sales load on investments of dividends bear any such added expense themselves.<sup>58</sup> A very few of them cover at least part of such costs by charging a transaction fee for each such investment.<sup>59</sup> Underwriters for funds that impose a sales load on dividend investments allocate a portion of the load to pay the added costs involved. However, the bulk of the sales load goes to the dealers that initially sold the shares on which dividends have been distributed.<sup>60</sup>

Only to the extent that the principal underwriter relieves the fund from the incremental cost of administering the investment of dividends, do shareholders receive anything in return for the sales load that they pay on invested dividends. However, transaction charges for such plans, which are designed only to cover these expenses, accomplish this same result at lower cost and more equitably than do sales loads. Most funds distribute income dividends quarterly. The sales load on dividend investments of \$100 annually amounts to \$8.50, more than five times the \$1.60 annual transaction charge which

<sup>53</sup> See pp. 223-232, *infra*.

<sup>54</sup> Source: Investment Company Institute. In 1965, 54.2 percent of all income dividends distributed by institute members was reinvested. These reinvested dividends amounted to \$432.2 million.

<sup>55</sup> Capital gains distributions are made from principal. This view has long been held by substantial elements in the mutual fund industry and is reflected in the statement of policy relating to investment company sales literature (Securities Act Release No. 3586, Investment Company Act Release No. 2621 (Oct. 31, 1957)). A load on reinvested capital gains would be "unconscionable" and "grossly excessive" within the meaning of sec. 22(b) of the Act, and an attempt to impose them would lead the Commission to propose a rule expressly banning them under sec. 22(c) of the Act. See pp. 40-41, *infra*.

<sup>56</sup> The imposition of such sales loads could violate the 9 percent limitation on sales loads for contractual plans specified in sec. 27(a) of the Act. See p. 218, *infra*.

<sup>57</sup> Arthur Wiesenberger & Co., Mutual Funds Charts and Statistics 1966.

<sup>58</sup> Rule 22d-1 under sec. 22(d) of the Act (17 C.F.R. sec. 270.22d-1) allows a fund to bear the entire cost of a dividend reinvestment plan if every shareholder is given the opportunity to reinvest his dividends at net asset value. If dividend reinvestment is only open to plan participants, the fund cannot bear the expenses of such a plan in excess of the cost of issuing dividend checks.

<sup>59</sup> For example, the George Putnam Fund of Boston charges each participant in its dividend investment plan 40 cents per transaction.

<sup>60</sup> The dealer concession often is a somewhat smaller portion of the load than that given on the original purchase.

One large fund assesses on each account for investments of dividends.<sup>61</sup> Moreover, sales loads are calculated as a percent of the purchase prices. Thus, an \$85 sales load on dividend investments of \$1,000 annually is over 50 times an annual transaction charge of \$1.60.

The practice of paying fund dealers a portion of the sales load on dividend investments long after the investor's original purchase sometimes produces anomalous consequences. One fund shareholder complained to the Commission that he had received a letter from a mutual fund dealer with whom he had no previous contact advising him that the dealer through which his investment program was initiated was no longer in business and that the principal underwriter had asked the inquiring dealer to obtain the shareholder's consent to receive the dealer concession on dividends automatically invested by him. This same shareholder also notified the adviser-underwriter of another fund in which he held shares that the dealer who was credited with the commissions on his dividend investments "has not been my broker for several years" and has had "nothing whatsoever to do with the reinvestments involved." In response, the adviser-underwriter offered to assign the account "to any broker of your choice."

Funds have followed a practice, to which the Commission has not objected, of not delivering prospectuses in distributions of new fund shares pursuant to dividend investment programs where the dividends are payable in cash or securities, at the shareholders' option, because, in the funds' view, they are not "sales" within the meaning of the Securities Act. The exaction of a sales load on each invested dividend is inconsistent with this view. Nor can such loads be justified on the ground that they are necessary incentives to "sell" dividend investments. Indeed, these loads appear to deter dividend investment. A sampling by the Investment Company Institute showed that 52.4 percent of all dividends were invested in additional fund shares, but that the investment rate for the funds which charged a sales load on such investments was only 29.9 percent.

Many shareholders are persuaded to enter into dividend investment programs in the normal course of making their initial investment. Sales presentations customarily point out the appreciation in fund investments over the past decade and demonstrate the greater appreciation that would have been possible if dividends and capital gain distributions had been invested. Other shareholders enter into dividend investment programs after their original purchase in response to mail solicitations by the funds themselves rather than by the dealers and salesmen who made the initial sales. Thus, sales loads on dividend investments generally are neither related to nor justified by any special selling effort.

Nor can sales loads on dividend investments be justified as compensation for the ancillary services mutual fund dealers sometimes provide for their customers. These services are usually informational in nature and no different from those customarily provided by broker-dealers without charge in order to attract and retain patronage. The maintenance of such continuing customer relationships is also important to dealers in mutual funds, since existing fund shareholders often are the best prospects for new sales.

<sup>61</sup> See note 59 on p. 215, supra.

## F. THE ADEQUACY OF EXISTING STATUTORY CONTROLS

1. *Disclosure*

The Securities Act in effect requires that a current prospectus be delivered to purchasers of registered securities prior to or at the time of delivery of the confirmation.<sup>62</sup> In the mutual fund industry, prospective purchasers commonly receive copies of the prospectus at the time of their initial contact with the salesman. Every fund prospectus discloses the amount of the basic sales load on its front cover page. In addition, the body of the prospectus sets forth the basic load, the reduced loads available for larger purchases and the dealer concessions.<sup>63</sup> These disclosures reflect the application to the distribution of mutual fund shares of the Securities Act's general disclosure requirements with respect to sales compensation.<sup>64</sup>

The Investment Company Act reflects, however, a congressional judgment that the disclosure requirements of the Securities Act are inadequate safeguards for investment company shareholders. In the area of sales loads, as in other areas of investment company activity, the Act supplements disclosure with additional controls, described below.

2. *Approval of unaffiliated directors*

Sales loads for mutual fund shares are specified in underwriting agreements between the funds and their principal underwriters. The Act requires, among other things, that a fund's underwriting contract and renewals of it be approved by a majority of the directors who are not parties to the contract or affiliated persons of any such parties or by the vote of a majority of the outstanding voting securities of the fund.<sup>65</sup> If the contract is to continue in effect for more than two years, it must be renewed at least annually by the directors, including a majority of the unaffiliated directors or by vote of a majority of the fund's outstanding voting securities.<sup>66</sup>

Whatever the sales load, the fund receives approximate net asset value for its shares.<sup>67</sup> This fact tends to reduce the interest of the fund's directors in the amount of the sales load, and is in marked contrast to the conventional underwriting situation. There existing shareholders and their managements have a direct immediate interest in the size of the underwriting spread, since it could dilute existing shareholders' equity and reduce the net prices sellers obtain. Hence conventional underwriters and sellers bargain with each other over the amount of such compensation as adverse parties.<sup>68</sup> In some cases underwriting compensation is determined by competitive bidding.<sup>69</sup>

3. *Statutory limitations on sales loads*

The most definite statutory limitation on sales loads relates to those charged in connection with the sale of periodic payment plan certifi-

<sup>62</sup> Secs. 2(10), 5(b).

<sup>63</sup> See Registration Form S-5.

<sup>64</sup> See pars. 17 and 18 of schedule A of the Securities Act.

<sup>65</sup> Act, sec. 15(c).

<sup>66</sup> Act, secs. 15(b) and 15(c).

<sup>67</sup> Act, secs. 2(a)(34) 22(a).

<sup>68</sup> In highly speculative markets, the combination of disclosure and negotiation sometimes has provided an ineffective check on underwriting compensation for unseasoned securities. The NASD has undertaken to review all such offerings for the purpose of evaluating the fairness of the underwriting arrangements. NASD Manual G-61. Moreover, underwriters' compensation is limited in a number of States. See ICS & Cowett, Blue Sky Law 67-68, 77-78, 329 (1958).

<sup>69</sup> See e.g., rule 50 under the Public Utility Holding Company Act of 1935 (17 C.F.R. sec. 250.50), which requires competitive bidding for securities of companies subject to the Commission's jurisdiction under that statute.

ates issued by contractual plan companies for the purchase of mutual fund shares on an installment basis. The Act expressly provides that the aggregate sales load for such plans cannot exceed 9 percent of the total payment to be made and that no more than one-half of the first year's payments or their equivalent can be deducted for sales load.<sup>70</sup>

With respect to sales loads generally, the Act does not impose express statutory limits. What it does is to give the Commission, the NASD and any other securities association which registers under the Exchange Act<sup>71</sup> rulemaking authority to prevent "unconscionable or grossly excessive" sales loads. Section 22(b) empowers such associations to adopt rules precluding "unconscionable or grossly excessive" sales loads on redeemable investment company securities. Section 22(c) authorizes the Commission to make rules and regulations applicable to principal underwriters and dealers "to the same extent, covering the same subject matter and for the accomplishment of the same ends" enumerated in section 22(b). Commission rules would supersede those of the association and obligate fund underwriters and dealers whether or not they are members of the association.<sup>72</sup>

The Commission has not adopted any rule pursuant to this authority. The NASD has adopted a rule which provides that no member shall participate in the offering or sale of mutual fund shares of which it is a principal underwriter if the public offering price includes a sales load "which is unfair, taking into account all relevant circumstances, including the current marketability of such security and all expenses involved."<sup>73</sup> This rule, however, has not been applied so as to affect sales load levels established by adviser-underwriters.<sup>74</sup>

#### 4. Retail price maintenance

Another of the Act's statutory controls with respect to sales loads—section 22(d)—prohibits dealers from selling redeemable investment company securities to the public "except at a current offering price described in the prospectus." This provision effectively prevents any price competition among dealers. Dealers must adhere rigidly to the offering price whether the shares they sell are newly issued or already outstanding if, as is almost always the case, those shares belong to a class that is currently being offered to the public by or through a principal underwriter.

##### (a) Background of section 22(d)

Section 22(d) is an exception to the usual congressional policy, expressed in the antitrust laws, against price fixing. No comparable

<sup>70</sup> See 27(a). Also, sec. 28(a)(2) of the Act requires face-amount certificate companies to maintain certain minimum reserves. This requirement limits sales charges on face-amount certificates.

<sup>71</sup> See, 15A, Seep. 62, supra.

<sup>72</sup> See, 22(c).

<sup>73</sup> Rule 26(d) of the NASD's Rules of Fair Practice. NASD Manual D-16.

<sup>74</sup> Sales of mutual fund shares are nearly always made on a riskless principal basis. Section 26(f)(2) of the NASD Rules of Fair Practice forbids members from purchasing mutual fund shares from the fund or a member of its distribution group (other than for investment) except to fill purchase orders already received. (NASD Manual D-18.) Nevertheless, such orders for fund shares are not covered by the NASD's 5 percent markup policy. For purposes of that policy, distributions of mutual fund shares are treated as conventional underwritings which are excluded from its purview. (NASD Manual G-8.)

The NASD's markup policy resulted from a survey of markups charged in 1943 by NASD members in over-the-counter transactions with retail customers. On that basis the NASD formulated a policy as to what constitutes unfair or unreasonable markups, which contemplates that for most transactions markups exceeding 5 percent of the contemporaneous interdealer market price will be deemed excessive. The NASD has found that a consistent practice of charging a full 5 percent markup on all over-the-counter transactions is unfair and contrary to just and equitable principles of trade. The 5 percent policy also applies to the combined charge in "proceeds transactions"—in which the customer sells a security and immediately purchases another with the proceeds of the sale. As previously noted, in fact most over-the-counter transactions are effected at sales charges considerably lower than 5 percent. See p. 212, supra.

provision was in the bill originally proposed to Congress by the Commission.<sup>75</sup> The proposal was first suggested by the industry<sup>76</sup> and set forth in a memorandum of agreement between the Commission and industry representatives submitted to Congress.<sup>77</sup> Although the legislative history is silent on the reasons for section 22(d), it appears to have been a response to the conditions in the industry prior to 1940, which were said to threaten disruption of the system of distribution through dealers under contract with the principal underwriters.

Prior to the enactment of the Act, "contract dealers"—those who had distribution agreements with the principal underwriter—were at a competitive disadvantage, which arose in two ways. First, they were obligated to sell fund shares at sales loads fixed by the principal underwriters while noncontract dealers were free to sell at whatever price they chose. Secondly, underwriting spreads were higher than they are now,<sup>78</sup> and noncontract dealers were able to obtain shares either directly from investors or from an over-the-counter trading market in redeemable investment company securities at prices somewhat lower than the prices that contract dealers had to pay to the principal underwriters, which prices reflected the underwriting spreads.<sup>79</sup> Since noncontract dealers were thus able to buy and sell more cheaply than contract dealers, there was a tendency for dealers to cancel their contracts with principal underwriters. The legislative history fails to show that any other response to this problem of competitive disadvantage—such as freeing contract dealers to meet price competition from noncontract dealers—was considered.

(b) *The uniqueness of section 22(d)*

The resale price maintenance provisions of section 22(d) are an exception to the general rule that in the over-the-counter markets charges for executing transactions are subject to negotiation.<sup>80</sup> Indeed the Exchange Act expressly prohibits registered national securities associations from adopting rules designed to fix minimum sales charges:

<sup>75</sup> S. 3580, 76th Cong., 3d sess. (1940).

<sup>76</sup> Senate Hearings 1057.

<sup>77</sup> Hearings Before a Subcommittee of the Committee on Interstate and Foreign Commerce of the House of Representatives on H.R. 10065, 76th Cong. 3d sess. (1940) ("House Hearings") 99.

<sup>78</sup> Illustrative are the principal underwriter's spreads in 1940 (and 1966) on shares of the following funds: Affiliated Fund, 3 percent (1.5 percent); American Business Shares, 3.1 percent (1.5 percent); Broad Street Investing Corp., 3 percent (1.5 percent); Bullock Fund, Ltd., 3.66 percent (2.66 percent); Century Shares Trust, 3 percent (2.5 percent); Fidelity Fund, 3.4 percent (1.5 percent); Fundamental Investors, Inc., 2.75 percent (1.75 percent); Keystone Custodian Funds, 3.3 percent (2.3 percent); Massachusetts Investors Trust, 2.5 percent (no change); and Wellington Fund, Inc., 3 percent (2 percent).

<sup>79</sup> The pre-1940 trading market is described in the Investment Trust Study, pt. 2, 324-325. That study also pointed out that principal underwriters' price to contract dealers were "higher by about 1 percent or more than the trading firms' wholesale offering price." *Id.* at 328.

<sup>80</sup> Although underwritten securities are almost invariably distributed to the public at a uniform price to which all participants agree to adhere, price fixing in conventional underwritings of securities generally exists only for very short periods. As soon as the underwriters dispose of the block that they have undertaken to distribute, a free market appears or, if the issue is not being offered to the public for the first time, reappears. Limited price maintenance for a short term has been deemed legally permissible on the ground that "the underwriting syndicate is an ad hoc common enterprise limited in number of participants, its purpose, and in duration," \* having the purpose of efficiently promoting, rather than restraining trade." *United States v. Morgan*, 118 F. Supp. 621, 690 (S.D. N.Y., 1953). See also *National Association of Securities Dealers, Inc.*, 19 S.E. 2d 424 (1945). Mutual fund underwriters, unlike those in most conventional underwritings, do not bear a risk that they may be unable to distribute a specific amount of securities at the offering price. More important, distribution of mutual fund shares is a continuous selling operation. Accordingly, retail price maintenance for mutual fund shares lasts perpetually. Fund retailers are competitors, not participants in a common enterprise of limited duration.

<sup>81</sup> Sec. 15(A)(b)(8) of the Exchange Act provides that the rules of a registered national securities association must "provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market," but states that such rules must not be designed "to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges."

Minimum commission rate schedules of course do govern transactions effected on national securities exchanges. This system has existed ever since the founding of the New York Stock Exchange in 1792, and Congress apparently concluded not to disturb it when the Securities Exchange Act of 1934 was adopted. In addition to historical factors, minimum commission rate schedules have been regarded by the exchange community as necessary to the orderly functioning of the central auction market on exchanges and to support the exchanges' extensive self-regulatory responsibilities under the Exchange Act. It has been suggested that if there were no fixed differential between the commissions charged by exchange members not on the floor and the commissions paid by them<sup>82</sup>—as would probably be the case absent a commission rate schedule—securities firms not represented on the exchange floor, which include a substantial number of exchange members, would have no incentive to retain membership or to submit to the self-regulatory and disciplinary functions of the exchange. These considerations, whatever their merits, are inapplicable to the distribution of mutual fund shares.

Exchange minimum commission rates differ from resale price maintenance for mutual fund shares in several other important respects. First, as noted, exchange commission rates are significantly lower—even on a round-trip basis—than mutual fund sales loads. Second, exchange minimum commission rates do not apply to dealers who are not exchange members, but the retail price maintenance provisions of section 22(d) require that *all* sales of mutual fund shares by *all* dealers be at "a current offering price described in the prospectus." Third, under the Exchange Act to protect the interest of investors the Commission is authorized to alter or supplement exchange rules relating to the fixing of reasonable rates of commission.<sup>83</sup> In contrast, section 22(d) specifically requires resale price maintenance by all mutual fund dealers at rates fixed by principal underwriters, subject only to the caveat of sections 22(b) and (c) that the Commission may by rule prohibit sales loads which are "unconscionable or grossly excessive."

The retail price maintenance provisions of section 22(d) also differ from State fair trade laws which validate certain types of contracts and restrictions on the alienability of chattels that would be unenforceable in the absence of express legislative enactments.<sup>84</sup>

Fair trade statutes leave the initiative for creating and for enforcing resale price maintenance entirely with the manufacturer. Price cutting is not made a crime and no enforcement agency acts to prevent it. For this reason, the enforcement of State fair trade laws is often sporadic or ineffective. By contrast, section 22(d) is a flat statutory prohibition, violations of which are subject to all of the sanctions contained in the Act, including disciplinary proceedings by the Commission or by the NASD. A retail dealer who willfully sold mutual fund

<sup>82</sup> See note 60 on p. 168, *supra*.

<sup>83</sup> Exchange Act, sec. 19(b)(9).

<sup>84</sup> The Federal statutes on the subject (the Miller-Tydings amendment to the Sherman Act passed in 1937, 50 Stat. 693, 15 sec. U.S.C. 1 and the subsequent McGuire Act enacted in 1952, 66 Stat. 632, 15 U.S.C. sec. 45) exempt from the Federal antitrust laws "contracts or agreements prescribing minimum or stipulated prices for the resale of a commodity \* \* \* when contracts or agreements of that description are lawful [in the State of resale]."