STATEMENT BEFORE
THE SECURITIES AND EXCHANGE COMMISSION PUBLIC CONFERENCE
ON RELATIONSHIPS BETWEEN INSTITUTIONAL MONEY MANAGERS
AND THE SECURITIES INDUSTRY

October 29, 1974

My name is John C. Bogle. I am Chairman and President of Wellington Fund, Windsor Fund, Ivest Fund, and eight other associated investment companies in that Group, with combined assets currently totalling $1.5 billion. I have spent my entire business career of 23 years in the investment company industry, and throughout this period I have been associated with this Group of investment companies. Until January of this year, I as also associated with Wellington Management Company, the investment adviser to, and distributor of, these Funds. I want to make it clear that while my comments today will draw on my experience in all areas of the investment company business, my vantage point in looking at the issues presented by the Commission in this conference is solely from the perspective of what appears to be in the best interests of the shareholders of the Funds I serve.

We are in the process of materially restructuring the relationships between our Funds and Wellington Management Company. Our Fund Group recently filed an application before the Commission for a number of exemptions from the Investment Company Act of 1940 to provide, in essence, for the formation of a new corporation, to be jointly owned by the Funds, which will perform, at cost, all administrative services required by the Funds (e.g., executive officers, financial, legal, accounting, pricing, shareholder services, communications, operations, etc.). Wellington Management Company, which had previously provided these services, would continue to serve the Fund as investment adviser and distributor. Thus, the Funds would become operationally

self-sufficient and independent of their adviser through a structural relationship that is, I believe, unprecedented in the mutual fund industry.

Under this arrangement, there would be no material change in our current practices with respect to the provision of investment-related services to the Funds since the present investment adviser will continue to perform such services under the new arrangement as heretofore. Thus, while our proposed corporate structure represents a radical departure from the general industry pattern, I believe that our practices with regard to the provision of investment-related services can be regarded as typical of a large ($1 billion—plus of assets) fund group in the investment company industry.

Let me summarize these practices briefly:

The investment adviser is employed by the Fund to manage the investment and reinvestment of its assets, to continuously review, supervise and administer the Fund's investment program, and to determine in its discretion the securities to be purchased or sold, subject in each case to the control of the Funds' officers and Board of Directors. In its fulfillment of these duties for the Funds, the adviser maintains an investment group of some 50 persons (consisting of about 30 professionals and 20 support personnel, but excluding those who are exclusively engaged in serving private investment counsel accounts of the adviser). This group includes policy executives, portfolio managers for the Funds, a research department and security analysts, an economic group, a fixed-income securities management group, a technical group and a trading group.

In return for providing these services, our investment adviser will receive (under the new arrangements) an annual fee averaging about 4/10 of 1% of Fund assets (about 45/100 of 1% for the smaller Funds, and about 30/100 of 1% for the largest). Investment-related services that are not provided within this fee structure in our case include principally Fund accounting, auditing, and portfolio pricing, custodianship of Fund cash and portfolio securities, and the brokerage costs involved in executing Fund

portfolio transactions. The basis for determining which services should be provided by the adviser has its roots in long tradition, industry trade practices (e.g., limits on stock exchange membership), law and regulation (e.g., custodianship requirements of the Investment Company Act of 1940), and, importantly, developing concepts of sound business and fiduciary practice (e.g., in our own case, the decision to separate the advisory function from the administrative function).

In any event, in carrying out the investment responsibility for the Funds, the investment adviser relies importantly on the securities industry. First, the securities industry is responsible for the actual execution and clearing of all Fund portfolio transactions. The adviser is responsible for the selection of the specific brokers and dealers to execute these transactions, and is directed to use its best efforts to obtain the best available price and most favorable execution.

Further, the securities industry provides significant amounts of investment information to the adviser in the form of the following types of material:

Stock and Bond Market Reports

Portfolio Strategy Recommendations

General Economic Data

Industry Studies

Individual Company Research Reports

Analyst-to-Analyst Contacts

Statistical Information

Technical Market Evaluation

This material is normally provided by securities firms which in turn receive brokerage commissions (so-called "soft dollars"). The Funds have authorized the adviser to place securities transactions with brokers or dealers who furnish such statistical research and other services to the Funds or the adviser, again subject to the requirements of seeking the best available price and most favorable execution, and maintaining as the first

consideration the benefits to the Funds and their shareholders. As our Fund prospectuses have generally pointed out, no regular formula is used in connection with these brokerage allocations and while such statistical and research services are made available for use by the adviser in providing investment advice, the adviser does not consider such information essential in the performance of its obligations under its contracts with the Funds, and is of the opinion that such information does not necessarily reduce its expenses.

In summary, the principal responsibility for the investment management of our Funds lies with the investment adviser, which utilizes the securities industry for the execution of transactions and for supplemental investment research. To put these relationships into perspective, the investment advisory fees paid to Wellington Management Company (under the proposed new arrangements) would approximate $6 million per year at present asset levels, while total brokerage commissions generated by our Funds in 1974 will approximate $5,200,000. Of this commission total, about $1,300,000 represents commissions directed to brokerage firms largely by reason of the research services they provide, but subject of course to "best price and execution" capability. (I should note that the adviser's research group maintains a detailed and continuing appraisal of the quality of the information received, and the trading group maintains a definitive list of brokerage firm execution capability ratings.)

The relationship between an investment adviser's management service and the securities industry's supplemental research must be considered in the light of the special nature of the mutual fund industry. Our Fund Group, which I believe is typical of a large firm in this industry, is comprised of eleven funds with varying investment objectives, and assets ranging in size from $5 million to $800 million. In total, these Funds currently own 307 different equity securities, in a list that is relatively concentrated among the well-known "blue chip" issues (as shown in Tabulation A attached). The 50 largest holdings of these securities account for 63% of the total value of our equity

holdings; the 100 largest account for 82% of the total. This relatively limited universe of relatively major companies in itself may differentiate our advisory and research needs from those of other types and sizes of institutions.

A few thoughts on the value of supplemental research that the securities industry provides to the mutual fund industry may be pertinent. Hardly an issue of the Institutional Investor magazine, it seems, fails to include a quotation from a senior executive of a major fund group who says "we could get along quite happily without any of it" (March, 1974, page 48), or "if they shut down Wall Street tomorrow, it would not mean a heck of a lot of change around here" (October, 1974, page 69). On the other hand, the Research Director of our investment adviser finds supplemental research extremely helpful, especially in the areas of monitoring industry developments, following companies not covered by the adviser, greater frequency of corporate contacts, and a wide range of background information. To the extent this appraisal is valid, of course, such research is a valuable service to our Fund shareholders.

Whether supplemental research is unnecessary, as its detractors say, or essential, as its proponents indicate, or somewhere in-between, I would give the securities research provided by Wall Street high grades in the broadcast economic sense. By providing an abundance of detailed, cogent, and up-to-date information on individual securities, this research plays a key role in giving American capital markets their well-deserved reputation as being the most efficient in the world. Despite its length, I would like to quote in this context the following section from the recent statement of Public Policy for American Capital Markets by the United States Department of the Treasury:

> "One desirable characteristic of capital markets is efficiency in determining the prices of securities. "Efficiency" in this context means the ability of capital markets to function so that prices of securities react rapidly to new information. Such efficiency will produce prices that are "appropriate" in terms of current knowledge, and investors will be less likely to make unwise investments. A corollary is that investors will also be less likely to discover great

bargains and thereby earn extraordinary high rates of return. Efficiency makes it difficult to be either a fool or a genius in selecting securities, although some investors may enjoy very high rates of return through luck, daring, or ability and others may suffer greatly through a variety of mistakes or from assuming great risks.

"Although efficiency eliminates much of the opportunity for extraordinary enrichment and may therefore seem undesirable, efficiency does insure that individual investors are not at a significant disadvantage compared to institutional investors in selecting securities and does increase the likelihood that savings will be channeled into investments in accordance with the risks and the promise of profit of the corporations whose securities are bought.

"Numerous studies of the American capital markets have indicated that they deserve high marks for efficiency both absolutely and relative to foreign markets. This efficiency has been promoted by the very large numbers of investors, the very large numbers of security analysts, the system of communication which provides for the rapid and widespread dissemination of information, the system of regulation, and the market mechanism itself which makes prices quickly responsive to the changes in views which are caused by new information.

"Efficiency seems to war with other characteristics which are often believed to be desirable. Efficient markets cause prices to change rapidly and, occasionally, dramatically in response to new information. Such changes are sometimes considered to constitute excessive volatility, something with which public policy should deal. When price changes are in response to new information, public policy should facilitate rather than impede them.

"Further, market efficiency results from the ardent, competitive quest for profits and for new information that will produce these returns. Those who secure new information first sometimes derive large profits from their knowledge. This sometimes creates a feeling that those who profit have an unfair competitive advantage. Principles of equity must be kept in mind in pursuing the goal of efficiency in determining prices of securities."

Under a competitive commission rate structure would this market efficiency be impaired? Would there be a significant diminution of investment information? In trying to answer these questions it might be useful to look at the way the brokerage activities of our Funds are conducted at the present time, in order to evaluate the implications of a fully competitive commission rate structure.

As shown in the attached Tabulation B (which covers commissions for both our Fund Group and private advisory clients of the adviser for the period January 1 to September 30, 1974), "regular" brokerage commissions of about $4 million represented the predominance of commissions generated, with another $776,000 representing the negotiated portion of listed trades. Our normal practice is to pay the fixed commission rate applicable to volume orders up to $300,000 and to negotiate the rate on the excess based on a generally-accepted guideline beginning at a point that is very close to one-half of the fixed amount. If the order appears to have been one of some complexity, cost, and difficulty, an additional amount might be added to the guideline commission on the negotiated portion; if the order is of particular ease and simplicity, the commission might be negotiated downward from the guideline. For example, assume we purchase 10,000 shares of a $40 stock. The first $300,000 carries a fixed commission of $.26 per share. Following the completion of the trade, we would begin our negotiation on the rate to be paid on the $100,000 excess over $300,000 at around $.13 per share. As a practical matter, depending upon the difficulty of the order, the commission on this excess would in general range from $.10 to $.16 a share. I should note that if the broker with whom we are working had positioned our block, our normal practice would be to pay the commission at the full fixed rate for the entire transaction.

Given these practices, substantially all (94%) of the commissions we use for research are derived from regular or fixed commissions rather than the negotiated portion of such commissions. Obviously, this commission category will no longer exist when rates become fully competitive, raising the question of the Funds' ability to generate comparable amounts of research brokerage in the future. If a structure emerges in which rates are not widely divergent, we would expect little change in our practices, and would endeavor to execute a major portion of our transactions with firms which also supply supplemental research to the adviser. On the other hand, if rates diverge sharply,

it will be difficult, if not impossible, to do so. Thus our planning envisions two possible scenarios which are worthy of further amplification.

One scenario for a future world of competitive rates might be that our Funds would have significantly less brokerage resources to dedicate to research commissions. It would seem highly likely, if this happens, that the remaining commissions would be concentrated with a smaller number of firms, that some of these services might be purchased from these firms for "hard dollars," and that some additional in-house capability might be developed by our adviser.

As to the greater concentration of research commissions, it seems reasonable to assume there is room for greater efficiency and more intensive utilization, so that such concentration would not impair the services now furnished to the adviser. In fact, the number of firms receiving brokerage commissions for research from our Funds has already declined from 250 in 1973 to about 150 presently. (Of those firms, the top 50 receive about 75% of all research commissions.) As to using "hard dollars," they would be far smaller in amount than the present "soft dollars." First, because where such services are available for cash they carry a cost of about one-third of the commission cost, and second, because utilization would be intensely scrutinized. For example, if one-third of the present supplemental research were used, at one-third the commission cost, the number of "hard dollars" required would be only one-ninth of the "soft dollar" total. Given this dimension, along with the continuing availability of <u>some</u> research commissions, and the assumption that the adviser's research group would need to be increased no more than modestly, it is difficult to foresee significant changes in our advisory fee structure in a world of fully competitive commission rates.

Further, what I have just described is only one scenario, and from Wall Street's view, a pessimistic one. A more optimistic scenario may well be that the move to competitive rates will not materially effect the availability of research commissions. It would seem quite possible that a structure may emerge in which rates are in effect

"posted" or generally accepted, developing in the manner of the present negotiated rate practices on that portion of orders over $300,000 which I described earlier, in which the majority of brokers have maintained similar rate structures. In this context, a rate structure could emerge which would encompass the provision of research services, since such services are generally valuable to institutions and individuals alike, and do not represent a large cost to the securities industry generally. A detailed study of these costs in the Institutional Investor Study (page 2265, Volume 4) indicated that the cost of providing research amounted to only 2.4% of the total expenses of New York Stock Exchange member firms in 1968 ($97 million of $4.0 billion). A more recent estimate (Institutional Investor, March, 1974, page 50) indicated that 3% of the securities industry's total costs were represented by investment research services. Thus, if the commission rate on a $40 stock remained in the general area of $.26-per share as at present, a firm might, as a theoretical matter, have a research cost of about ¾ of a cent built into that commission. It is difficult to believe that costs of this small dimension could not continue to be assumed by a firm desiring to provide research, particularly if it were able to offset this difference with such elements as size, managerial competence and the like. In any event, this scenario seems a more optimistic one.

No matter which of these two scenarios is the more likely, I have some trouble in accepting the concept that the Funds in our investment company group should "pay up" in brokerage commissions in return for research services. Our advisory contracts have been consistent in requiring that the adviser seek the best price and most favorable execution, and to do otherwise raises some very difficult questions of business practice and of fairness.

On the business practice side, the trading department that serves our funds, it seems to me, must conduct its affairs in accordance with the fundamental precept of "best price and execution." The wisdom of placing extraneous constraints on the conduct of their professional activities is highly dubious, since to mix research and execution

must, in some intangible way, make the trading process more complicated and difficult. Further, as a matter of fairness, it is difficult, if not impossible, to assure that the specific fund which "pays up" for a certain trade with a broker who has provided research has in fact been the beneficiary of this research. That is to say, Fund A may pay an extra $.10 per share in a trade for 10,000 shares of IBM to a brokerage firm which has provided research on General Motors which has been helpful to Fund B, a member of the same investment company group. While these kinds of differences cannot be readily quantified, and may even be negligible over time, the problem is more than merely theoretical. (I should also note, probably more than parenthetically, that the question of "paying up" for supplemental research that is deemed beneficial to the Funds is difficult to divorce from the question of "paying up" for <u>any</u> service deemed beneficial. At this point, the analogy of Pandora's box comes to mind.)

Let me conclude with just a few brief thoughts about the questions of possible governmental action and of additional safeguards to protect fund shareholders. As to governmental action, I would urge only that Congress and the regulatory bodies continue to work toward clarity and consistency in their approach to investment institutions. Clarity in developing appropriate fiduciary standards and sound trade practices will be especially necessary in the coming world of competitive rates. Consistency of regulation also seems mandatory as competition has increasingly blurred the distinction between banks and trust companies, insurance companies and investment advisers. The difference in regulation and in investor protection accorded to clients of each, however, continues to be dramatic. Another area where consistency must be employed is in the rules governing access to the central market. In sum, if the competition is to be fair, the regulation must be even-handed.

As to additional investor protection for mutual fund shareholders, it is difficult to see what might be necessary. Of all of the industries involved in the world of institutional investing, only the mutual fund industry, under the Investment Company Act

of 1940, affords its shareholders a full range of protection. In general, mutual fund Boards of Directors are largely independent of the investment adviser, and, in our case at least, are in the process of taking a major step forward in translating that theoretical independence into the reality of practical independence. Clearly, a strong and well-informed Board of Directors (or, in the case of other types of institutions, a similarly constituted body) is the best assurance that the interests of the beneficiaries of the huge pools of investment capital in our nation's major financial institutions will be well served.

TABULATION A

WELLINGTON FUND AND ASSOCIATED FUND GROUP
COMMON STOCK HOLDINGS

Rank	Name	(+000) $Value	% of Holdings	Cumulative
1	A T & T	$ 53,665	5.78	5.78
2	IBM	50,435	5.44	11.22
3	Exxon	24,969	2.69	13.91
4	Kennecott Cooper	24,539	2.64	16.55
5	Union Carbide	20,516	2.21	18.76
6	Union Pacific	18,132	1.95	20.71
7	Ford Motor	17,516	1.89	22.60
8	Safeway Stores	17,280	1.86	24.46
9	Martin Marretta	16,482	1.78	26.24
10	Xerox	14,841	1.60	27.84
11	CBS	13,031	1.40	29.24
12	FMC Corp.	12,901	1.39	30.63
13	Superior Oil	12,717	1.37	32.00
14	Texas Instruments	12,528	1.35	33.35
15	R. J. Reynolds	12,450	1.34	34.69
16	Kerr-McGee	12,196	1.31	36.00
17	Phelps Dodge	11,796	1.27	37.27
18	General American Transportation	10,291	1.11	38.38
19	Travelers Corporation	9,875	1.06	39.44
20	Getty Oil	9,788	1.05	40.49
21	ACF Industries	9,734	1.05	41.54
22	Digital Equipment	9,473	1.02	42.56
23	Interco	8,702	0.94	43.50
24	Gulf & Western	8,554	0.92	44.42
25	Firestone	8,325	0.90	45.32
Next 25 Stocks		163,545	17.60	62.92
Next 50 Stocks		176,873	19.06	81.98
Next 100 Stocks		137,029	14.72	96.70
Next 108 Stocks		29,679	3.30	100.00
Total	308	$927,862	100%	- - - -

* Wellington Fund, Windsor Fund, Ivest Fund, Trustees' Equity Fund, Exeter Fund, Gemini Fund, Explorer Fund, W. L. Morgan Growth Fund, Wellesley Fund, Westminster Bond Fund and Fund for Federal Securities.

TABULATION B

WELLINGTON FUND AND ASSOCIATED GROUP*
BROKERAGE COMMISSIONS PAID
January 1 – September 30, 1974

Type of Execution	Regular	Negotiated	Imputed	Fixed	Total
	----Type of Commissions----				
Agency:					
Non-Block	$ 3,610	346	20	48	$4,024
Block	282	168	2	14	466
Principal:					
Non-Block	63	16	418	141	638
Block	81	246	2,678	280	3,285
Total	$4,036	$ 776	$3,118	$483	$8,413

Commissions allocated for Research: $1,709,000

By type of Commission:	Regular	94%
	Negotiated	6%
By type of Execution:	Non-Block Agency	97%
	Block Agency	3%

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* Wellington Fund, Windsor Fund, Ivest Fund, Trustees' Equity Fund, Exeter Fund, Gemini Fund, Explorer Fund, W.L. Morgan Growth Fund, Wellesley Income Fund, Westminster Bond Fund and Fund for Federal Securities. In addition, includes investment counsel affiliate, which accounted for approximately one-half of all commissions.

** Block trades defined as 10,000 shares or more. "Regular commissions" are commissions not subject to negotiation; "negotiated commissions" are those on portions of listed trades in excess of $300,000; "imputed commissions" are those attributable to principal transactions in over-the-counter market (largely bonds); "fixed commissions" are for underwritings; computer transaction services; and fourth market.