MUTUAL FUND DISTRIBUTION AND SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940

Submitted By

DIVISION OF
INVESTMENT MANAGEMENT REGULATION

SECURITIES AND EXCHANGE COMMISSION

AUGUST 1974

OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

NOV 4 1974

Honorable John Sparkman
Chairman of the Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

When the Senate Committee on Banking, Housing and Urban Affairs considered the 1970 Amendments to the Investment Company Act (the "Act"), it requested the Commission's views on the repeal of Section 22(d), which requires retail price maintenance.* Because the Commission indicated that it lacked sufficient information upon which to base a recommendation, the Committee asked that the Commission study the consequences of repeal and report to it as soon as practicable.

Such a study was conducted by the Commission's staff and its report, entitled "The Potential Economic Impact of the Repeal of Section 22(d) of the Investment Company Act," was transmitted to the Committee in November 1972. Neither it nor the Commission's letter of transmittal made any express recommendations as to what should or should not be done about Section 22(d). Before making any definitive recommendations, the Commission determined to hold public hearings to explore the major issues in the marketing of mutual funds and to reexamine traditional administrative positions which affect them. The hearings were held in February and March of 1973 and dealt not only with whether Section 22(d) should be repealed but also with the broader question of what can and should be done to enable investment companies to bring their message to the investing public more economically and effectively than has heretofore been the case.

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* The term "retail price maintenance" has been generally used, and is used in this letter, to describe the pricing practices required by Section 22(d). However, this type of pricing is different from retail price maintenance for consumer and other goods. The price of mutual fund shares has two components: the net asset value which fluctuates depending on the value of the fund's portfolio and, in many cases, a sales charge. Sales of shares at less than net asset value would result in dilution of the assets of the fund, and would clearly be detrimental to the interests of existing shareholders. Therefore the only aspect of the practice required by Section 22(d) which bears any resemblance to retail price maintenance for consumer goods is the requirement that the sales charges specified in the prospectus be binding on all dealers.

As a general policy, the Commission believes it appropriate to promote efficiencies in securities distribution through retail price competition. However, implementation of this policy in the distribution of mutual fund shares is not an easy task. Simply stated, it is our judgment that neither the industry nor the investing public would benefit from the disruption that might arise upon immediate repeal of Section 22(d). Accordingly, the Commission does not recommend such a drastic step. Instead, we intend to exercise our available administrative authority to encourage the industry to move toward competition. At the same time, we are requesting that Congress provide the Commission with clear administrative authority to modify the operation of Section 22(d) in light of experience gained with the initiatives we propose.

We are pleased to transmit a report prepared by our Division of Investment Management Regulation which reviews the mutual fund distribution system today and discusses the elements of our recommended program in greater detail.

BACKGROUND

The subject of mutual fund distribution has been an important part of a series of reports and studies made for and by the Commission over more than a decade. As early as 1962, it was considered as part of a Study of Mutual Funds conducted for the Commission by the Securities Research Unit of the Wharton School of the University of Pennsylvania. This was followed in 1963 by the Special Study of the Securities Markets, which included discussion and recommendations with respect to certain aspects of the marketing of mutual funds. Following the Special Study, the Commission dealt more specifically with the marketing of mutual fund shares in its 1966 report on the "Public Policy Implications of Investment Company Growth." There the Commission found that the sales charges for mutual fund shares bore "no reasonable relationship to the cost of investing in other types of securities." The Commission reasoned that the recommendations of securities firms and their salesmen could be unduly influenced, perhaps subconsciously, by major differences in sales compensation and that some degree of equalization in the level of compensation for selling different types of securities might be appropriate. Therefore, the Commission concluded that the cost of purchasing mutual funds should be lowered.

At that time, the Investment Company Act effectively insulated mutual fund sales charges from price regulation and price competition. That is, until 1970, Section 22(b) of the Act gave the National Association of Securities Dealers (the "NASD") and the Commission rulemaking authority to prohibit only "unconscionable or grossly excessive" sales charges on mutual fund shares. This permissive standard, combined with the retail price maintenance provisions of Section 22(d), prevented both effective price regulation and effective price competition.

In connection with the legislative recommendations growing out of its 1966 Report, the Commission considered having sales loads determined by competition among retail dealers through repeal of Section 22(d). However, the Commission was uncertain what effects repeal of Section 22(d) would have on mutual fund distribution, and it also considered a variety of regulatory solutions to the problems it saw in the sales load area. As a compromise, the Commission acquiesced in a proposal to amend Section 22(b) to give the NASD rulemaking authority, with Commission oversight, to prevent mutual funds from being sold at a sales load which is "excessive." Congress adopted this solution. At the same time, your Committee requested that the Commission study the consequences of repeal of Section 22(d).

In a related development, in February 1971, the Commission completed its Institutional Investor Study Report. In its letter transmitting that report to Congress, the Commission recognized that, to the extent that elimination of fixed minimum commission rates would reduce or cut off an important source of income for distributors of mutual fund shares, direct sales charges or payments to fund sellers would have to be increased -- or mutual fund distribution would have to be curtailed -- unless lower cost distribution methods were developed. The Commission indicated that it preferred the development of such lower cost distribution methods.

THE HEARINGS

At the February and March, 1973, hearings, some seventy persons appeared and more than 100 written comments were filed. The testimony and comments made clear that the mutual fund industry is beset by new and serious difficulties quite different from the spectacular growth which the Commission reviewed in its 1966 Mutual Fund Report. Record sales of earlier years have given way to net redemptions; competing products

have made substantial inroads; fund managers have diversified into other fields; many fund underwriters have allowed their relationships with small broker-dealers to deteriorate; and the industry has become increasingly dependent for sales upon large broker-dealers to whom mutual funds are a relatively unimportant source of income. Moreover, in many cases retailers fail to provide adequate service to fund shareholders after the initial sale. At the same time, the mutual fund distribution system continues to cause many purchasers to pay for services which they do not want or need.

In reexamining our traditional administrative positions with respect to mutual funds, we found that the operation of the regulatory system has made it difficult for funds to take advantage of some of the marketing practices traditionally used to stimulate demand, including effective advertising and mass-merchandising techniques such as group discounts. In addition past restrictive Commission interpretations with respect to Section 22(d) not only prohibit price competition among retailers but also discourage price competition among funds, underwriters and complexes. In sum, the regulatory framework has encouraged funds to rely upon intensive personal selling efforts -- an inefficient and expensive method of distribution.

Meanwhile, changes in brokerage allocation practices of mutual funds, the reduction in mutual fund brokerage resulting from the onset of fully competitive stock exchange rates, and competition from other financial products which can be more easily sold on the basis of current yield (and which also offer attractive incentives to salesmen), make it increasingly difficult for mutual funds to compete successfully for the salesman's favor, even while they are hampered in developing market demand among investors. In short, the mutual fund industry's historic reliance upon high fixed sales charges to induce salesmen to "push" fund shares, besides being expensive for investors, is simply not working today.

THE COMMISSION'S REASONING

It is clear that the present retail price maintenance system has produced a distribution system which can and should be improved upon. The Commission has concluded that price competition at the retail level is a desirable goal. It appears to us, however, that the immediate abolition of Section 22(d) would serve the interests of neither the public nor the industry.

Honorable John Sparkman
Chairman of the Committee on Banking,
Housing and Urban Affairs
United States Senate

For more than three decades, the marketing strategy of the mutual fund industry has been to rely almost exclusively upon a sales "push" rather than a demand "pull;" or, as is often said, fund shares are "sold, not bought." In this environment, it would be unrealistic to suppose that a sudden end to retail price maintenance would be accompanied by the level of investor sophistication and sensitivity to sales loads that would be needed to make a price competitive distribution system work. The more likely result of a precipitous end to retail price maintenance would be an end to widespread distribution of mutual fund shares, and most Americans would not have an opportunity to consider investing in mutual funds. As a consequence, many mutual funds - which by their nature tend to be self-liquidating and, therefore, require continuous distribution - would be adversely affected.

No issuer of securities is subject to more detailed regulation than a mutual fund. Implicit in the decision of Congress to establish a thoroughgoing statutory scheme to govern mutual funds is, we think, a determination that mutual funds are a product which, with appropriate safeguards, should be made available to the public. While the Commission would not suggest that any particular investor should buy mutual funds, neither is it presently prepared to take or recommend action which might result in an abrupt end to fund distribution.

Therefore, the Commission has chosen a middle path, intended to reduce or eliminate many of the inequities and inefficiencies of the present fund distribution system while, at the same time, avoiding the dangers of a sudden abolition of retail price maintenance. We have decided to exercise fully our existing administrative powers to lay the groundwork for the gradual and orderly introduction of retail price competition into the mutual fund distribution system.

The Commission's aim is to allow the industry to adopt voluntarily programs designed to set the stage for retail price competition. In order to assure that the Commission will have adequate authority to move the industry in this direction in a meaningful way if such action should prove to be in the public interest, we shall also request that Congress expand the Commission's authority to select from a broad variety of long-range options for administrative actions which might later be taken to remove any lingering inhibitions upon competition. Such action would be taken if experience indicates an undue lack of willingness in the industry to take advantage of the opportunities which we intend to provide or if the Commission concludes that regulatory action should be taken to hasten movement toward a more competitive environment.

OUR PROGRAM

As first steps, we will permit greater opportunities for the cultivation of public demand for mutual fund shares by allowing greater flexibility in fund advertising and more meaningful portrayal of investment results in fund sales literature. Our program will also provide greater opportunities for mass-marketing by allowing quantity discounts and other price variations for a wide variety of groups including all employer-employee groups. Certain proposals for rule amendments necessary to implement these recommendations have already had long exposure and are at a point where immediate action can be taken.

In addition, we will shortly publish for comment proposed rules which will be designed to allow investment companies and their underwriters increased opportunities to initiate price variations. These will include a rule which would allow underwriters to provide for periodic "open seasons" during which persons who have held shares for at least a specified period could buy additional shares at a reduced price, and a rule relieving issuers of variable annuities from the restrictions of Section 22(d), provided that they do not engage in any unjust price discrimination. We will also view favorably applications for exemption from Section 22(d) to permit combination discounts where mutual funds and other financial products distributed by the same underwriter are purchased from the same retailer.

Moreover, two steps are planned which will permit some price flexibility at the retail level through increased opportunities for brokered transactions. We intend to ask the NASD to adopt a rule to prohibit contractual restrictions which could prevent dealers from engaging in brokered transactions in fund shares. If necessary, we might adopt a complementary rule under the Investment Company Act to prevent funds from restricting the transferability of their shares in a secondary brokered market. In addition, we will authorize our staff, on an experimental basis, to view favorably interpretive requests with respect to proposals that brokers which act independently of funds and their underwriters be permitted, under certain circumstances, to charge reasonable fees for services rendered in connection with the purchase of shares of "no-load" funds.

Finally, we are notifying the NASD that we would not object to the adoption, with certain minor changes, of the full service maximum sales load rule which it formulated pursuant to the 1970 amendments to the Act. The rule permits a sales load of up to 8 1/2 percent to be charged only

by those funds which offer dividend reinvestment at net asset value, rights of accumulation and certain volume discounts. Funds failing to offer such features would be subject to lower maximum sales loads. We endorse the basis of this proposal, not because we wish to promote further regulation in this area, but because it is a worthwhile measure which can provide improved protection to investors in the form of a more rational sales load structure. It is an expedient method to promptly remedy certain aberrations in the present structure by assuring that only those funds which offer the full range of ancillary services may charge the maximum sales load.

Each of the administrative steps described above is feasible at the present time. The Commission believes that all of these measures are within its existing authority, and each is aimed at improving the existing mutual fund distribution system while at the same time allowing the industry voluntarily to move toward price competition.

At the appropriate time, when these programs have been implemented and the industry has had a fair opportunity to function under them, we will be in a position to consider adoption of more far-reaching administrative actions. These could go as far as prohibiting retail price maintenance in the fund industry and establishing a secondary dealer market in fund shares, or they could stop short of that but, for example, permit contract dealers to sell fund shares at any sales load they chose above the underwriter's spread, provided such a pricing structure is indicated in the fund's prospectus. We believe, however, that legislative action is necessary to clarify our authority to implement these possible future measures to achieve more effective price competition in the sale of fund shares. In the near future, we shall forward a specific legislative recommendation to accomplish this.

We fully recognize that the approach we have determined to follow does not represent the simplest means of dealing with the problems of mutual fund distribution. We could have elected to forego any attempt to modify substantially the fund distribution system, preferring instead continuation of the status quo, perhaps with slight modifications. At the other extreme, we could have concluded that Congress should promptly repeal Section 22(d) and let the mutual fund industry sink or swim in sudden and complete price competition. The middle path we have chosen will enable the Commission and the industry to move toward the goal of price competition in an orderly manner. With our authority clarified, we will be in a position, if we determine to do so, to establish a timetable for adoption of further-reaching programs aimed at eventual elimination of all retail price maintenance. A regulatory agency seems

particularly well-suited to perform the task of adapting the regulatory framework in response to changed conditions. It is the genius of the administrative process that the intent of Congress can be effectuated in a complex and specialized area by an agency which is provided with flexibility and discretion to adjust the law as circumstances demand.

In transmitting the report, the Commission wishes to express its gratitude to Allan S. Mostoff, the Director of the Division of Investment Management Regulation, Anne P. Jones, the Associate Director of the Division, and Lewis J. Mendelson, an Assistant Director of the Division who supervised the overall staff effort. A special acknowledgment is due to Joel H. Goldberg, Acting Special Counsel, who provided the principal writing and editorial effort. Many other members of the Commission's staff, both within and without the Division of Investment Management Regulation, were of incalculable assistance. While all of them brought great talent and devotion to the task, special mention is due the following present and former members of the Division's staff: Alan Rosenblat, Chief Counsel; Sidney Cimmet, Assistant Chief Counsel; Seymour Spolter, Stanley B. Judd and John Ake, Special Counsels; Michael R. Virga and Richard Q. Wendt, Actuaries; John P. Freeman, Richard Grant, Herbert Haywood, and Marcia Newman, Attorneys; Samuel S. Stewart, Jr., Chief Financial Analyst; Paul J. Heaney, Financial Analyst; Sandra S. Monje, Staff Assistant; Kenneth Gerstein, Student Legal Assistant; and Paula J. Milasi, Debra J. Riston, Karen C. Ryan, and Edith Bobby, Secretarial Assistants.

By direction of the Commission:

Ray Garrett, Jr.
Chairman

REPORT

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT
REGULATION

August 1974

To: The Chairman and Members of the
Securities and Exchange Commission

I am pleased to transmit the Division's report with respect to mutual fund distribution and Section 22(d) of the Investment Company Act of 1940.

When the Senate Committee on Banking, Housing and Urban Affairs considered the 1970 Amendments to the Investment Company Act, it requested the Commission's views on the repeal of Section 22(d), which requires retail price maintenance in the sale of mutual fund shares. Because the Commission indicated that it lacked sufficient information upon which to base a recommendation, the Committee asked that the Commission study the consequences of repeal and report to it as soon as practicable.

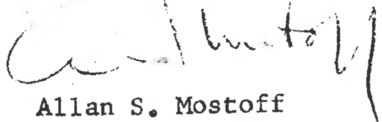
Such a study was conducted by the Commission's staff, and its report, entitled "The Potential Economic Impact of the Repeal of Section 22(d) of the Investment Company Act," was transmitted to the Committee in November 1972. Neither it nor the Commission's letter of transmittal made any express recommendations as to what should or should not be done about Section 22(d). Before making any definitive recommendations, the Commission determined to hold public hearings to explore the major issues in the marketing of mutual funds and to reexamine traditional administrative positions which affect them. The hearings were held in February and March of 1973 and dealt not only with whether Section 22(d) should be repealed but also with the broader question of what can and should be done to enable investment companies to bring their message to the investing public more economically and effectively than has heretofore been the case.

The attached report presents an overview of the positions taken by the participants at the hearings, and sets forth the conclusions which the Division feels should be drawn. In brief, it is the Division's view that the retail price maintenance requirement has produced a distribution system which can and should be improved upon. Although we do not believe that full price competition at the retail level is a practical alternative today, the Division recommends that the Commission exercise fully its existing administrative powers to lay the

groundwork for the gradual and orderly introduction of retail price competition into the mutual fund distribution system while immediately alleviating some of the problems resulting from the present regulatory framework. At the same time, the Division recommends that the Commission request that Congress expand the Commission's authority to select from a broad variety of long-range options for administrative actions which might later be taken to move the industry to a more competitive environment.

In forwarding the report, I wish to especially acknowledge the assistance of Anne P. Jones, the Associate Director of the Division and Lewis J. Mendelson, an Assistant Director of the Division who supervised the overall staff effort in preparing the report. Particular credit is due Joel H. Goldberg, Acting Special Counsel, who provided the principal writing and editorial effort. Many other members of the Commission's staff, both within and without the Division of Investment Management Regulation, made important contributions. While all of them brought great talent and devotion to the task, special mention is due the following present and former members of the Division's staff: Alan Rosenblat, Chief Counsel; Sidney Cimmet, Assistant Chief Counsel, Seymour Spolter, Stanley B. Judd and John Ake, Special Counsels; Michael R. Virga and Richard Q. Wendt, Actuaries; John P. Freeman, Richard Grant, Herbert Haywood and Marcia Newman, Attorneys; Samuel S. Stewart, Jr., Chief Financial Analyst; Paul J. Heaney, Financial Analyst; Sandra S. Monje, Staff Assistant; Kenneth Gerstein, Student Legal Assistant; and Paula J. Milasi, Debra J. Riston, Karen C. Ryan and Edith Bobby, Secretarial Assistants.

Respectfully submitted,



Allan S. Mostoff
Director

MUTUAL FUND DISTRIBUTION AND SECTION 22(d)
OF THE INVESTMENT COMPANY ACT OF 1940

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Letter to Chairman Sparkman, Committee on Banking, Housing and Urban Affairs from Chairman Casey, November 1972.

Investment Company Act Release No. 7475, November 3, 1972.

Investment Company Act Release No. 7635, January 18, 1973.

Rules Proposed by NASD for the Regulation of Sales Charges in the Distribution of Investment Company Shares.

Alphabetical Index of Participants in Mutual Fund Distribution Hearings.

Chronological Index of Participants in Mutual Fund Distribution Hearings.

I. INTRODUCTION, BACKGROUND AND SUMMARY OF RECOMMENDATIONS

A. INTRODUCTION

In November 1972, the Commission published a study prepared by its then Office of Policy Research, which considered the impact of a possible repeal of Section 22(d) of the Investment Company Act of 1940. 1/ The study dealt with, among other things, the costs of distributing mutual funds, the significance of revenue derived by brokerage firms from mutual fund sales, and the significance of mutual fund sales to the securities markets.

In transmitting the report to the Senate Committee on Banking, Housing and Urban Affairs, which had requested the study, 2/ the Commission said that:

> "[I]ts findings certainly suggest there is no compelling public interest in continued retail price maintenance in this field and that the repeal of Section 22(d) would on balance be desirable." 3/

However, the Commission pointed out that the report contained no express recommendations, and that:

> "Before making any definitive recommendations to the Congress as to what should or should not be done about Section 22(d), the Commission will hold public hearings at which interested persons will be asked to direct our attention to aspects of the mutual fund sales compensation problem that the report may have overlooked or to which it may have given insufficient weight." 4/

Public hearings conducted in February and March of 1973 provided an opportunity for in-depth exploration of the major issues in the marketing of mutual funds and the laws and regulations which affect them. In addition to focusing on Section 22(d), and in order to view the question of the impact of repeal in the total context of fund distribution processes, traditional administrative positions were re-examined in light of changing conditions in the securities markets and the mutual fund industry. A broad range of subjects were covered including further liberalization of advertising rules, measurement and portrayal

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1/ SEC, Report of the Staff on the Potential Economic Impact of a Repeal of Section 22(d) of the Investment Company Act of 1940 (1972), ("OER [Office of Economic Research] Report").

2/ S. Rep. No. 91-184, 91st Cong., 1st Sess. 8 (1969), ("1969 Senate Report").

3/ Letter of Transmittal of OER Report from William J. Casey to the Honorable John Sparkman, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, November 1972, at vi (Appendix A).

4/ Ibid.

of investment results and the possible reexamination of the Statement of Policy, and proposed rules to permit grouping or pooling of orders for the purpose of obtaining quantity discounts.1/ The hearings also provided an opportunity to consider the NASD's full service maximum sales load rules.2/

In addition, one of the principal thrusts of the inquiry was to determine whether the situation with respect to mutual fund distribution today is comparable to that in 1966, when the Commission was wary that mutual fund distribution practices could possibly distort

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1/ ICA Rel. No. 7475 (November, 1972) (Appendix B), outlined the matters to be considered as follows:

A. Repeal of Section 22(d) of the Act.
   1. Complete repeal.
   2. Partial repeal.
   3. Price competition within a limited range.
   4. A current public offering price described in the prospectus.
   5. Prohibiting price competition from non-contract dealers.

B. Rules under Section 22(b) and other provisions of the Act.
   1. Lower breakpoints reflecting the reduced cost of diversification on larger purchases.
   2. Regulation of the dealer discount.
   3. Continuous discounts.
   4. The value of additional product features.
   5. Contractual plans.

C. Further liberalization of advertising rules.
   1. Advertising.
   2. Statement of Policy.

D. Simplified, more readable mutual fund prospectuses.

E. Group sales.

F. Reducing paperwork in small transactions.

G. No-load sales.

H. Development of an adequate economic data base.

2/ The NASD's proposed rules provide for maximum sales load schedules. For those funds which offer certain product features -- dividend reinvestment at net asset value, lower breakpoints for volume discounts and rights of accumulation -- the maximum load would be 8-1/2% of the offering price. Without those features, the NASD has described the ceiling for sales of up to $25,000 as no higher than 6%.

the investment recommendations of dealers selling fund shares 1/ and impose excessive costs upon investors,2/ or whether different conclusions are appropriate at this time.

Fifteen days of hearings were held, beginning on February 12, 1973, and ending on March 28, 1973. Some seventy persons appeared, including representatives of the Department of Justice, the National Association of Securities Dealers ("NASD"), mutual fund underwriters and managers, trade associations (including the Investment Company Institute ("ICI"), the No-Load Fund Association, the Securities Industry Association, the Independent Broker Dealers Trade Association, the National Mutual Fund Managers Association, and the American Life Insurance Association), leading distributors, insurance industry representatives, large and small broker-dealers, independent economists, and financial analysts specializing in the fund management industry. In addition to the oral presentations, there were more than 100 written submissions, many of which were quite extensive.

The presentations and questioning of persons at the hearings were supplemented by panel discussions on the following topics: advertising, grouping for quantity discounts, measurement and portrayal of investment performance, value of service as an element of the NASD sales charge rule, the consequences of complete repeal of Section 22(d), possible modifications of Section 22(d), and trends in mutual fund distribution. Additional panels consisted of representatives of small broker-dealers and of the National Mutual Fund Managers Association, whose members are heads of the mutual fund departments of New York Stock Exchange member firms.

This Report discusses the issues presented in the staff study and the hearings, analyzes the different options with respect to them, and sets forth the Division's recommendations on each.

B. BACKGROUND

1. Prior Studies & Legislative Efforts

The hearings were the culmination of a series of studies and reports describing mutual fund distribution which traced back to the Study of Mutual Funds by the Securities Research Unit of the Wharton School of The University of Pennsylvania ("Wharton Report"). 3/ The Wharton Report concluded with respect to fund distribution that "[i]ntensive sales effort has been one of the important characteristics contributing to the expansion of mutual funds." 4/

1/ Report of the SEC on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 180 (1966), ("Mutual Fund Report"). The Commission's concern in this area arose in the context of the then prevalent practices of reciprocal brokerage business and "give-ups".

2/ Id., at 21.

3/ H.R. Rep. No. 2274, 87th Cong., 2d Sess. (1962).

4/ Id., at 31.

It found a significant relationship between fund asset size and the size of the sales load. 1/ It also indicated that in a substantial number of cases advisory income was being used to subsidize the underwriting function. 2/ Apart from the rivalry between load and no-load funds, the Wharton Report observed that there has been little price competition in the mutual fund industry at the investor level. 3/

Shortly thereafter, in 1963, the Commission delivered to Congress the Special Study of the Securities Markets, 4/ which included a discussion of aspects of the marketing of mutual funds. The Special Study's recommendations with respect to mutual fund selling practices have largely been acted upon. They included improved supervisory controls and surveillance of selling practices, 5/ refinement of prospectus requirements to assure that basic information would be brought clearly and conspicuously to the attention of the prospective investor, 6/ and increased protections with respect to front-end load contractual plans. 7/

Following the Special Study, the Commission in 1966 dealt more specifically with the marketing of mutual fund shares in its Mutual Fund Report. 8/ At that time, Section 22(b) gave the Commission and the NASD rulemaking power to prevent only "unconscionable or grossly excessive" sales loads on mutual fund shares. That permissive standard, combined with the retail price maintenance provisions of Section 22(d), meant that federal law effectively insulated mutual fund sales charges from both price competition and price regulation. As was stated by former Chairman Budge:

> "The fact that a given product ultimately benefits the purchaser does not justify a price for it which is neither competitively determined nor subject to a type of regulatory control which is an adequate substitute for such competition." 9/

1/ Ibid.

2/ Id. at p. 32.

3/ Id. at p. 35.

4/ H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

5/ Id., part 5, at 170.

6/ Id. at 170-71.

7/ Id. at 171.

8/ P. 3, n. 1, supra.

9/ Hearings on H.R. 11995, et al. Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 91st Cong., 1st Sess., 91-34, pt. 2, at 864 (1969), ("1969 Hearings").

In the Mutual Fund Report the Commission found that the sales charges for mutual fund shares displayed "no reasonable relationship to the cost of investing in other types of securities." 1/ It concluded that, although some difference between such sales charges and those on listed securities may be warranted, 2/ the existing disparity had consequences which extended beyond the matter of costs in that they could lead securities firms and their salesmen to recommend and sell mutual fund shares rather than other securities. 3/ The Commission reasoned that the recommendations of securities firms and their salesmen could be unduly influenced, perhaps subconsciously, by major differences in sales compensation and that some degree of equalization in the level of compensation for selling different types of securities may "avoid a possible distortion of investment decisions and a resulting impact upon the functioning of the markets for reasons extraneous to relative investment merit." 4/ Therefore, the Commission in 1966 concluded that the cost of purchasing mutual fund shares should be lowered. 5/

The Commission had considered four approaches to this problem: 6/

1/ Mutual Fund Report at 221.

2/ Id. at 21.

3/ Id. at 221.

4/ Id. at 222.

5/ Ibid. The Commission also concluded, in part because of the retail price maintenance provisions of Section 22(d), that principal underwriters competed for the favor of retail dealers in the sale of fund shares and that this has had the effect of raising rather than lowering prices to the investor. It reasoned that because Section 22(d) suppresses the downward pressures that normal market forces might otherwise exert, there is nothing to offset the upward pressure on sales loads that results from vigorous competition among principal underwriters for the favor of dealers and salesmen. As a result of Section 22(d):

> "the investor who is already convinced of the investment merits of mutual fund shares and has already decided to buy a particular fund's shares must - if he chooses a load rather than a no-load fund - pay sales charges designed to cover selling efforts that he does not want, does not need, and does not get."

During the 1967 Senate hearings on S. 1659 former Chairman Cohen summed up this problem very simply as one of "excessive costs." Hearings on S. 1659 Before the Committee on Banking, Housing and Urban Affairs, 90th Cong., 1st Sess. 51 (1967), ("1967 hearings").

6/ See 1967 hearings, Statement of the SEC by Chairman Cohen, appendix, at 173-174.

(1) A regulatory solution -- imposing a 5% maximum on fund sales loads or graduated reductions from present levels until the 5% level was reached;

(2) Having sales loads fixed by competition among retail dealers -- repeal of the price maintenance provisions of Section 22(d);

(3) A combination of the first two approaches i.e., permitting competition on the portion of the load in excess of 5%; and

(4) Authorizing the NASD, with Commission oversight, to adopt rules preventing "excessive" sales loads and requiring "reasonable" maximum sales loads.

While admitting that repeal of Section 22(d) appeared in many ways more attractive, 1/ the Commission nevertheless recommended the direct regulatory solution -- a 5% maximum sales load with Commission power to raise or lower the maximum when circumstances or conditions warrant. 2/ It also recommended that the Act be amended to permit the Commission to prohibit sales loads on the reinvestment of dividends. 3/

The Senate Committee on Banking, Housing and Urban Affairs, when it considered the Commission's recommendations, also gave thought to deleting Section 22(d) from the Investment Company Act. 4/ When asked for its views on this question, the Commission indicated that it was uncertain what repeal would mean to the market and to mutual fund sales organizations. It suggested that it lacked sufficient information, particularly economic information, for recommending that 22(d) be eliminated. 5/

1/ Id. at 174.

2/ Mutual Fund Report, at 223. The 5% figure was considered by the NASD to be the outside limit on the mark-up that ordinarily can be charged on a securities transaction, including a transaction in which the customer sells one security and buys another. See 1969 hearings, statement of Chairman Budge, at 865.

3/ Mutual Fund Report, at 223.

4/ 1969 Senate report, at p. 8.

5/ Hearings on S. 34 and S. 296 before the Committee on Banking, Housing and Urban Affairs, 91st Cong., 1st Sess. 18-19 (1969), testimony of Commissioner Owens.

As a compromise, the Commission acquiesced in a proposal to amend Section 22(b) to give the NASD rule-making authority to prevent mutual funds from being sold at a sales load which is "excessive". 1/ Congress adopted this solution. It also amended Section 22(b) to provide that the NASD rules governing mutual fund sales loads must allow for reasonable compensation for sales personnel, broker-dealers and underwriters, and reasonable sales loads to investors. 2/ The 1970 amendments gave the NASD, with Commission oversight, authority to promulgate rules to achieve such sales loads and further provided an 18-month interval between passage of the Act and the effective date of the section, to permit the NASD to

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1/ See 1969 hearings, statement of Chairman Budge, at 865.

2/ As amended in 1970, Section 22(b) now provides in pertinent part:

"(b)(1) Such a securities association may also, by rules adopted and in effect in accordance with said section 15A, and notwithstanding the provisions of subsection (b)(8) thereof but subject to all other provisions of said section applicable to the rules of such an association, prohibit its members from purchasing, in connection with a primary distribution of redeemable securities of which any registered investment company is the issuer, any such security from the issuer or from any principal underwriter except at a price equal to the price at which such security is then offered to the public less a commission, discount, or spread which is computed in conformity with a method or methods, and within such limitations as to the relation thereof to said public offering price, as such rules may prescribe in order that the price at which such security is offered or sold to the public shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors. The Commission shall on application or otherwise, if it appears that smaller companies are subject to relatively higher operating costs, make due allowance therefor by granting any such company or class of companies appropriate qualified exemptions from the provisions of this section."

study "all relevant factors" in order to provide a basis for its rule proposals. 1/ At the same time, the Senate Committee requested that the Commission study the consequences of repeal of Section 22(d) and report to it as soon as reasonably practicable. 2/

Following the 1970 Amendments, the Commission, in its February 1971 letter of transmittal accompanying its Institutional Investor Study Report, gave some indication of the approach it thought the NASD Study should take. It pointed out that to the extent the elimination of fixed minimum rates would cut off an important source of income for distributors of mutual fund shares, the direct charges for selling fund shares would have to be increased -- or mutual fund distribution would have to be decreased -- unless lower cost methods of distribution were developed. The Commission indicated that it favored the development of such lower cost alternatives, and it suggested that the NASD Study focus upon ways in which existing costs of distribution might be reduced and savings passed on to fund purchasers. The Commission also said that it would consider the feasibility of achieving this result in connection with its own study of Section 22(d). 3/

Both the NASD study pursuant to 22(b) and the Commission's staff study of the Potential Economic Impact of Repeal of Section 22(d) were concluded during 1972. Although the Commission and the NASD shared certain facilities in making these studies, they were conducted independently of each other.

The NASD Study, entitled "An Economic Study of the Distribution of Mutual Funds and Variable Annuities", was prepared pursuant to contract with Booz-Allen & Hamilton, Inc. Portions of the NASD Study and recommendations were submitted to the Commission in June and August of 1972, and the remainder in October of that year. Both that study and the Commission's Staff Report, which was published in November of 1972, were the subject of considerable discussion at the 1973 hearings.

1/ 1969 Senate report, at p. 18.

2/ Id. at 8.

3/ Institutional Investor Study Report of the SEC, House Doc. No. 92-84, 92d Cong., 1st Sess., pt. 8, at xix-xx (1971)("Institutional Investor Study Report").

C. Summary of Report and Recommendations

The Industry Today

The hearings confirmed that the mutual fund industry is faced with a disrupted marketing system. Record sales of earlier years have given way to net redemptions; competing products have made substantial inroads; fund managers have diversified into other fields; and the fund industry, which in many cases has operated at a distribution deficit, has allowed its relationships with small broker-dealers to deteriorate, while it has become increasingly dependent for sales upon large broker-dealers to whom mutual funds are a relatively unimportant source of income. Moreover, the funds' relationships with some investors have been strained by the excesses of the "go-go" era of the 1960's and a failure to provide adequate service to many small shareholders.

The Positions of the Participants

Representatives of the mutual fund industry, including the Investment Company Institute and managers of major funds, generally opposed repeal of Section 22(d), arguing that the fund distribution system depends upon retail price maintenance. Broker-dealers, while in some cases complaining of mutual funds' practices, also opposed repeal of Section 22(d).

On the other hand, the Department of Justice urged an immediate end to retail price maintenance, either by legislative or administrative action. Two economists, Professor Henry C. Wallich and Dr. Donald Farrar, favored eventual retail price competition but were of the view that immediate repeal of Section 22(d) would not be feasible. Dr. Farrar recommended gradual erosion of the section while Professor Wallich recommended a transition to negotiated sales loads by stages.

The Recommendation of the Division: Gradual Changes in the Distribution Process Through Administrative Action

The Commission is committed to the general proposition that the securities industry should operate -- to the extent possible -- in an environment of free and vigorous price competition. In the mutual fund industry, however, the Division does not believe that it would be possible to move quickly to retail price competition without seriously disrupting the distribution of fund shares. In view of the open-end self-liquidating nature of mutual funds, such disruption should be avoided, if at all possible, and certainly minimized. Accordingly, the Report recommends a program pursuant to which the industry could move toward price competition on a limited basis at first and the Commission could assess the effects of that competition before taking further action. 1/

1/ In addition to the program described herein, a number of possibilities have been discussed since the hearings which could affect the distribution of fund shares, but which are not included in this Report.

The Commission held hearings on September 10-12, 1974, to review suggested interpretations and amendments to the NASD Anti-Reciprocal Rule. (Securities Exchange Act Rel. No. 10867, June 20, 1974). Those hearings considered a broad range of issues, including the amount and methods of compensating dealers for the sale of fund shares; possible anti-competitive effects of sales reciprocals; whether fund shareholders (as distinguished from purchasers of fund shares) should bear selling expenses; and, of course, questions of best price and execution and possible distortion of broker-dealer recommendations of fund shares. The matter is now under review by the staff.

Representatives of the broker-dealer community have also suggested that sales load ceilings should be raised in order to pay for the follow-up services they render or that follow-up services should be purchased separately.

Finally, representatives of fund complexes have asked the staff to consider the possibility that funds be permitted to bear some of the cost of distribution directly, pursuant to rules which might be drafted under Section 12(b) of the Act.

In the initial stages of the recommended program, the basic retail price maintenance system would be retained, but the Commission would take various actions to encourage voluntary price competition. The Report proposes a number of rule-making and interpretive steps designed to make it possible for funds and their underwriters to get their story across in a manner not now possible and to encourage the use of price variations in the sale of fund shares.

Relaxation of advertising restrictions is recommended as well as proposed modifications of the Statement of Policy. This should provide more useful information to investors and permit funds and their underwriters to communicate with them directly in a more effective way. These two proposals should encourage the development of more of a demand "pull" to supplement -- and possibly replace -- the present heavy reliance on sales "push".

In another area, the report recommends that the Commission provide opportunities for mass-marketing by allowing discounts for a wide variety of groups including all employer-employee groups. This should also lead to greater competition among underwriters and funds through price variations.

The report also proposes a number of other steps designed to afford funds and their underwriters increased opportunities to initiate price variations. Such variations should make possible increased economies and efficiencies in fund distribution and enable the industry to reduce certain inequities caused by the present pricing structure. The recommended variations include: (1) a rule which would allow funds and their underwriters to provide for periodic "open seasons" during which persons who have held shares for at least a specified period, say, one year, could buy a specified amount of additional shares at a reduced price; (2) an indication that the Commission would view favorably applications for exemption from Section 22(d) to permit combination discounts where mutual funds and other financial products distributed by the same underwriter are purchased from the same retailer; (3) a rule relieving issuers and distributors of variable annuities from the restrictions of Section 22(d), provided they do not engage in any unjust price discrimination; and (4) steps which will permit some price flexibility at the retail level through increased opportunities for brokered transactions with respect to both load and no-load funds.

The report also recommends that the Commission request an amendment of Section 22(d) to enable the Commission to take further steps toward the ultimate goal of retail price competition. As the final element of the program, the Report takes the position that the Commission should not object to the adoption of the NASD's proposed full service maximum sales load rule, provided certain minor changes are made in it.

Recommended Program

A. Measures Designed to Encourage a Degree of Voluntary Price Competition

1. Steps to Permit Funds to Communicate More Effectively With Investors

a. Advertising

Advertising can be an effective merchandising tool, but current restrictions inhibit its use by mutual funds. For this reason, and because one result of increased price competition might be that less emphasis would be placed on salesmen so that funds would have to rely on other means to stimulate demand for their products, the Report proposes, as an integral part of the recommended program, that the Commission liberalize the advertising restrictions in Rule 134: (1) to allow fund advertising to be more interesting by permitting the use of attention getting devices and designs; (2) to allow fund advertising to be more informative by permitting the inclusion of more objective details about the fund; and (3) to permit joint tombstones and more objective information about the adviser, thus placing greater emphasis on the adviser.

b. Portrayal of Performance

In addition to liberalized advertising rules, fund sales literature should permit investors to make more meaningful comparisons of past investment returns, risks and costs. To achieve this goal the Commission's Statement of Policy, which prescribes methods for portraying investment results, needs revision. Accordingly, the Report recommends publication for comment of an amendment to the Statement of Policy which would allow the use of proposed charts permitting portrayal of investment results on a total return basis. As proposed, "total return" would permit a single figure which includes the compound effects of capital gains distributions, dividends, and changes in the value of the original share over ten years, provided that risks, including variability in returns from year to year, and the effects of expenses are also clearly shown. This should facilitate more meaningful comparison of fund results and a clearer understanding of how differences in expenses can affect compound returns. Applying the same principles to the investment results and expenses of variable annuities should foster greater understanding of how costs affect variable annuity investment results as well.

2. Measures Designed to Introduce More Price Variations into the Sales Load Structure

a. Expanded Group Sales

Rule 22d-1 permits quantity discounts to "any person," a term defined to include corporations, qualified employee retirement plans and certain other entities, but which excludes a group of individuals established for the purpose of buying fund shares. The Report recommends that the Rule be amended to permit certain additional groups to take advantage of volume discounts and other price variations. This recommendation will enable funds and their underwriters to introduce mass-marketing techniques and to pass on to investors economies of scale and cost savings from group sales. Greater utilization of this marketing technique should also lead to increased public awareness of mutual funds and cause both the industry and the public to become more sensitive to price and product variations.

b. Unsolicited Purchases

The Report recommends an exemptive rule which would permit a fund and its underwriter to utilize "open seasons" during which repeat investors could invest in the fund in which they already hold shares, at a reduced load or at no-load, thereby enabling qualifying investors to avoid paying for selling services they do not need or get. Such a rule would provide for adequate notice to existing shareholders, and since "open seasons" would be optional, they could be discontinued if they tended to discourage dealers from selling fund shares by depriving them of commissions from follow-up sales. A holding period would be required before the open season could be availed of and the amount which a repeat investor could purchase under the arrangement would be limited. This proposal should encourage funds and their underwriters to give more attention to existing shareholders, and those funds with an adequate performance record and large numbers of satisfied shareholders should find it particularly helpful. The Report also recommends that the Commission indicate that it will show greater flexibility in the future in reviewing individual applications for exemption from Section 22(d) to permit reduced or eliminated sales charges to unsolicited new investors where it can be shown that such arrangements would be in the best interests of investors and would not disrupt fund distribution.

c. Purchases of Fund Shares in Combination With Other Financial Products Distributed by the Same Principal Underwriter

The Report recommends that the Commission indicate a willingness to go somewhat beyond the exemptions which already have been granted with respect to combination sales to permit, on application, price reductions to purchasers who have previously or contemporaneously purchased, from the same retailer, another investment product or an insurance product, distributed by the same underwriter. Such exemptions would permit cost savings from selling several products during one sales effort to be passed on to investors and would also permit underwriters to experiment with varied financial packages. In addition, they would introduce another price variation which in itself could help cultivate price sensitivity among investors. With adequate experience, it may be feasible ultimately to develop an exemptive rule in this area.

d. Exemption of Variable Annuities from Section 22(d)

The Report recommends that the Commission propose a rule to exempt completely the sale of variable annuities from Section 22(d), provided their sales load structure does not discriminate unjustly. In this area, such an approach is preferable to the gradual approach recommended for mutual funds, since the removal of mandatory retail price maintenance would probably not have any negative impact upon the distribution of variable annuities, a product which is not easily transferable in a secondary market.

e. Price Flexibility in Brokered Transactions

1. Sale of Fund Shares by One Person to Another Through an Agent

By its terms, Section 22(d) does not apply to brokered transactions. Nevertheless, no secondary market in mutual funds has developed largely because uniform sales agreements between underwriters and broker-dealers effectively prevent such a secondary market.

The Division believes that a brokered secondary market would be beneficial. 1/ Although such a market is not likely to become so significant as to disrupt the primary distribution system, it would introduce retail price variations in the industry and perhaps also provide some insight into whether a secondary dealer market could function effectively.

1/ The Report takes the position that pending litigation as to the legality of such restrictions in sales agreements need not delay implementation of this recommendation.

The Report therefore recommends that the Commission request the NASD to amend its Rules of Fair Practice to prohibit restrictions against a secondary brokered market. It further recommends that, if necessary, the Commission propose a rule under Section 22(f) to prevent funds from accomplishing the same result as is presently obtained in sales agreements by restricting the transferability of their shares.

2. Purchase of No-Load Shares through a Broker Charging a Fee

Permitting a broker to make a reasonable charge in connection with purchases of no-load shares could (1) provide him with an incentive to recommend no-load securities; (2) compensate brokers for services rendered in connection with no-load purchases; and (3) encourage some load funds to become no-load. For these reasons, the Report recommends that the Commission clarify the circumstances under which such a charge may be appropriate.

B. Recommended Legislative Proposals for Expanded Authority to Take Subsequent Administrative Actions

The above recommendations are designed to provide an environment in which the industry can and will voluntarily adopt programs designed to set the stage for retail price competition.

The Commission already has sufficient authority to take the recommended administrative actions outlined above. As contemplated, none would require a fund or its underwriter to revise its marketing strategy; at the outset this would be left to competition. If this does not work, however, and if effective retail price competition does not develop, the Commission should have the authority to move the industry in that direction by making some of the optional steps mandatory, if such action should appear appropriate.

The Report therefore recommends that the Commission request legislation to clarify its administrative authority in this regard, as well as to take further steps to require competition among funds and underwriters, permit competition at the retail level, or even require an end to retail price maintenance.

C. Recommended Regulatory Safeguards

Pursuant to the 1970 Amendments to Section 22(b), the NASD has formulated a proposed rule which would provide maximum sales load levels. As it has described the rule, the maximums which would be permitted are:

8.50% for purchases of up to $10,000 or $15,000;
7.75% for purchases between $10,000 and $25,000; or
7.50% for purchases between $15,000 and $25,000; and
6.00% for purchases of $25,000 and over.

The right to charge a maximum load would be contingent on the fund offering: (1) dividend reinvestment at net asset value; (2) rights of accumulation; and (3) volume discounts. The NASD has deferred action on this proposal pending Commission recommendations.

The Report takes the position that it would not be appropriate to impose tighter limits at this time, and, as a practical matter, sufficient economic data are not available to permit formulation of better rules. Since the NASD rule ties the right to charge the maximum sales load to the product features offered by a fund, its implementation, as an interim measure, would introduce some rationality into the sales load structure. For these reasons, the Report recommends that the Commission not object to adoption of the NASD rule subject to modification to require (a) a sales load reduction for funds which fail to offer exchange privileges; and (b) lower sales charges for so-called cash management funds.

II. THE INDUSTRY TODAY

The mutual fund industry today is vastly different from that portrayed in the Commission's 1966 Mutual Fund Report although there are, of course, certain similarities. For example, the Mutual Fund Report noted that though the industry's total assets were spread over 379 companies, 1/ the 52 funds making up the ten largest complexes accounted for more than half of the total. 2/ While the number of active mutual funds has risen to 798 as of June 30, 1974, the phenomenon of industry concentration, as depicted in Chart I below, continues as in the past. 3/ There is likewise a marked similarity between the industry's merchandising strategy today and in 1966. The 1966 Report observed a clear tendency of load fund underwriters to direct their appeal to compensation conscious fund retailers rather than price conscious investors.4/

1/ Mutual Fund Report 44.

2/ As of June 30, 1966, fund industry assets were $38.2 and the 52 funds in the ten largest complexes held 55 percent of all mutual fund assets.

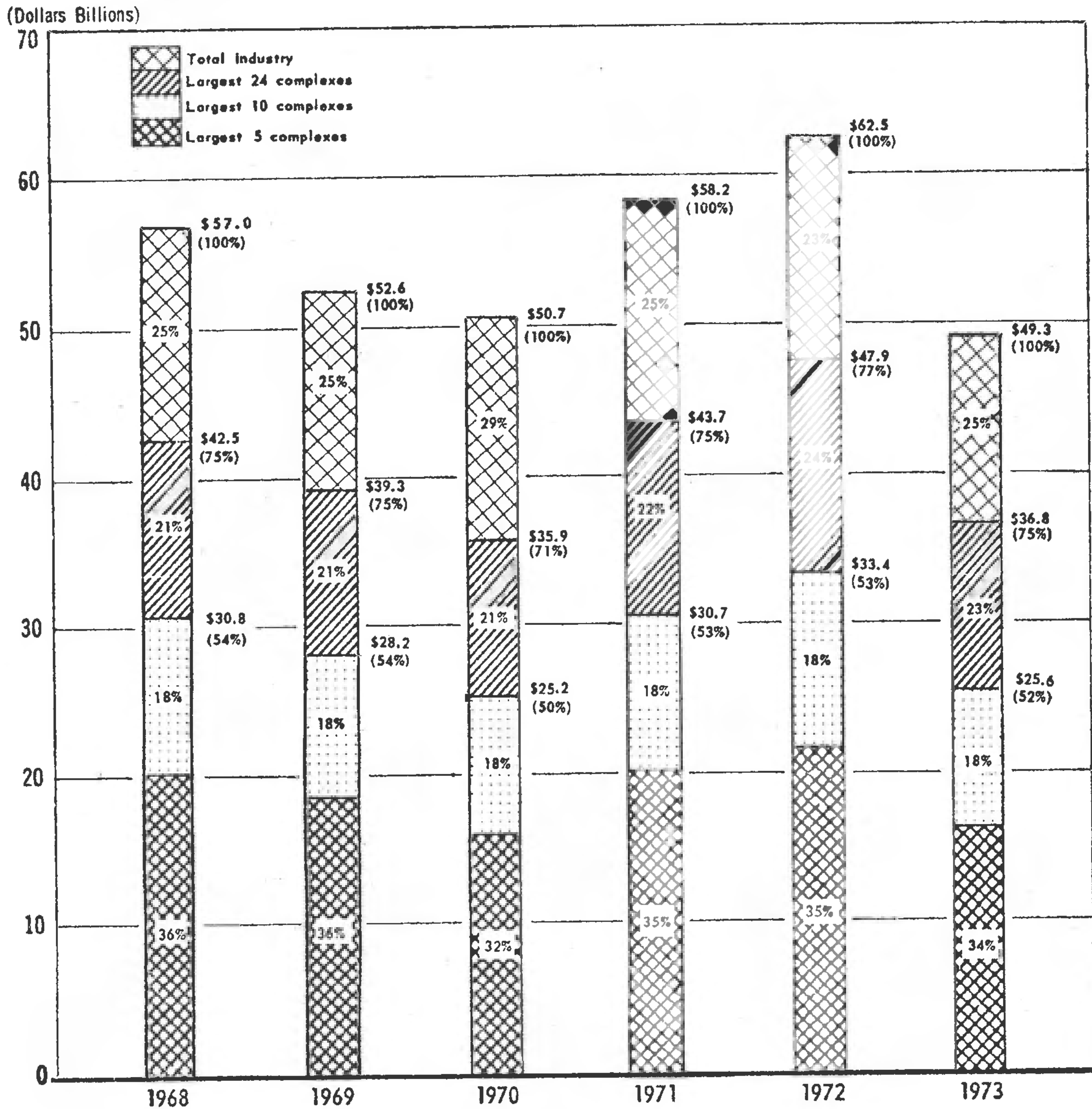
3/ Paralleling the 1966 concentration situation, as of June 30, 1974, the seventy-four funds making up the ten largest complexes accounted for roughly half of the industry's assets.

Although the complexes comprising the groups of largest firms have varied somewhat over the years, it is fair to say that, in general, the largest complexes have maintained their positions. That is, of the 5 largest complexes, 4 have been in the top 5 steadily since 1968; similarly, 7 of the present top 10 have been in the top 10 since 1968. Of the 3 complexes which have not been in the top 10 throughout this period, two have been in the top 10 for 5 out of 6 years, each of them being eleventh in one year. The third is a no-load fund complex which was eighteenth in 1968, and has risen each year to its position of ninth. Finally, 16 of the 24 largest complexes have been among the top 24 each year since 1968, and 4 more have been among the top 24 in 5 of those six years.

4/ Mutual Fund Report at 209.

CHART I

Percentage of Total Assets of Mutual Funds By Largest Complexes



Note: *In 1973 the 24 largest complexes managed 170 funds out of an industry total of 736 funds.*

SOURCES:

1. Wiesenberger Services, Inc., Investment Companies (1969-74 editions).
2. SEC, "Classification, Assets, and Location of Registered Investment Companies (1969-73 editions).
3. "Vickers Directory of Investment Companies" (March, 1974 ed.).

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Though the no-load segment of the fund industry has enjoyed substantial growth since the time the Report was published,1/ it is clear that price inelasticity 2/ and the concomitant premise that load fund shares are sold, not bought, are still key characteristics of the mutual fund merchandising approach.3/

While these characteristics remain, and the industry today is still dominated by a handful of complexes and is still dependent upon the basic sales "push" strategy of the load funds, the distribution hearings disclosed important differences from the situation that prevailed in 1966. The most telling contrast is at the bottom line: net redemption status has lately replaced the sales records the industry earlier enjoyed. Net redemptions totaled $3.2 billion in 1972-73, 4/ and between February 1972 and July 1974 ICI members as a group were in net redemption every month but four. 5/

But even the net redemptions do not tell the full story. The hearings developed the picture of an industry faced with a disrupted marketing system:

(A) Many other financial products are now competing actively for investment dollars the funds previously had much to themselves;

1/ The Report listed total fund industry assets at $38.2 billion as of June 30, 1966, with no-load funds accounting for only $2.1 billion (5.1%) of that total. Id. at 52. Mutual fund assets were $54.4 billion as of June 30, 1973, with no-load funds making up $7.1 billion (13.1%) of that amount. SEC, 39th ANNUAL REPORT 149 (1973). The growth enjoyed by the no-loads is discussed further at pages 20-22 below.

2/ Price inelasticity is used in the sense that investors have not been encouraged to develop a sensitivity to sales load variation.

3/ Dr. Stephen F. Sherwin, a consultant to the NASD, testified on this point at the fund distribution hearings:

STAFF QUESTION: "Is it also your assumption, if 22(d) were repealed, that investors would be price conscious, that the sales would be affected because investors would be price conscious?"

DR. SHERWIN: "....I doubt very much that there is a high elasticity. I would be willing to go further. I think there is an extremely inelastic demand for load funds. I think the industry said in one respect, it is true all along, that load funds are sold, but not bought." Tr. 54-55.

4/ See ICI "1974 Mutual Fund Fact Book," p. 9 (hereinafter "ICI Fact Book").

The impact of the unique fund redeemability feature and the importance of continuing sales of fund shares is underscored by the fact that funds experienced these net redemptions in spite of gross sales for ICI member funds of $9.3 billion during those years.

5/ ICI, "Open-End Company Monthly Statistics." In May and June of 1974 net sales of ICI member companies totaled $59.5 million. The funds' net sales status for those two months is in large part attributable to sales by cash management funds of $169.3 million for the period. ICI News Release, July 22, 1974. Cash management funds are discussed at pp. 133-35.

(B) Fund distribution, seldom profitable in and of itself in the best of times, seems to have become even less profitable (or more unprofitable) lately, thus requiring greater subsidization of distribution from advisory profits;

(C) The industry's "road to market," traditionally through small broker-dealers, has changed significantly as the funds have placed increasing emphasis on selling through NYSE member firms;

(D) The excesses of some fund complexes during the "go-go" era of the 1960's, and the failure of some brokerage firms and fund complexes adequately to serve the needs of their customers, seem to have generated among some investors a distrust of mutual funds as an investment medium; and

(E) At a time when it is reported that only three out of every ten households "know something" about mutual funds, 1/ indicating a large untapped potential demand for the fund concept among small investors, the sales efforts of the fund industry have increasingly ignored this potentially lucrative market in favor of the relatively sophisticated "big ticket" investor.

A. Vigorous Competition From Other Financial Products

As pointed out by the ICI in its written submission, many financial products are now competing actively for the investment dollars mutual funds previously captured. 2/ Relatively new equity products such as REIT's, oil and gas drilling funds and mass merchandised discretionary accounts have been built around the valuable fund characteristics of professional management and diversification of investment and have enjoyed significant marketing success. Brisk competition for investor favor is not just a result of pressures from outside the investment company industry. Within the industry itself, load funds have been losing sales to no-load funds, offerings of closed-end companies and unit trust bond funds. The magnitude of the load funds' marketing problems is illustrated by Table I and Chart II set forth below which show the net sales over 1971-73 of load funds, no-load funds, closed-end investment company offerings, registered offerings of REIT's and new offerings of unit trust bond funds.

The reputation and success of one large no-load fund complex provides a plausible explanation for the contrast between the net redemption status of load funds and the net sales enjoyed by the no-loads. As for other investment media, their relative success at a time when load fund demand has waned can be seen as attributable, at least in part, to two factors. First, some competing products offer substantial compensation to the salesman, thus tending to diminish or even eliminate the traditional sales push edge of the load funds. Second, some of these competing products are better positioned to exploit the recent shift in investor demand for safety of principal and a high yield in the face of the disappointing performance of the equity markets.

1/ ICI, "The Public's Attitude Toward Mutual Funds," prepared by National Analysts, Inc. (1971), p. 2.

2/ Written Comment of ICI, File No. 4-164, p. 37-38.

TABLE I

NET SALES (or Net Redemptions) in 1971, 1972 and 1973 of LOAD AND NO-LOAD FUNDS, AND OFFERINGS OF CLOSED-END COMPANIES, REIT's AND UNIT TRUST BOND FUNDS

	1971 (mil)	1972 (mil)	1973 (mil)	Three Year Total
Load funds 1/ net sales (redemptions)	$138.90	($1,987.80)	($1,496.70)	($3,345.60
No load funds 1/ net sales	258.20	317.60	204.70	780.50
Closed-End Companies (new offerings) *	2/ 420.00	2/ 1,119.55	3/ 1,517.00	3,056.55
Real Estate Investment Trusts 2/ * (equity shares)**	878.50	565.20	507.50	1,951.20
Unit Trust Bond Funds 2/ (new offerings)*	540.80	985.18	1,309.55	2,835.53

1/ Includes only companies reporting sales to the Investment Company Institute. Source: Chart 2, ICI Monthly Statistical Analysis Reports.

2/ Source: Commission records of effective registrations.

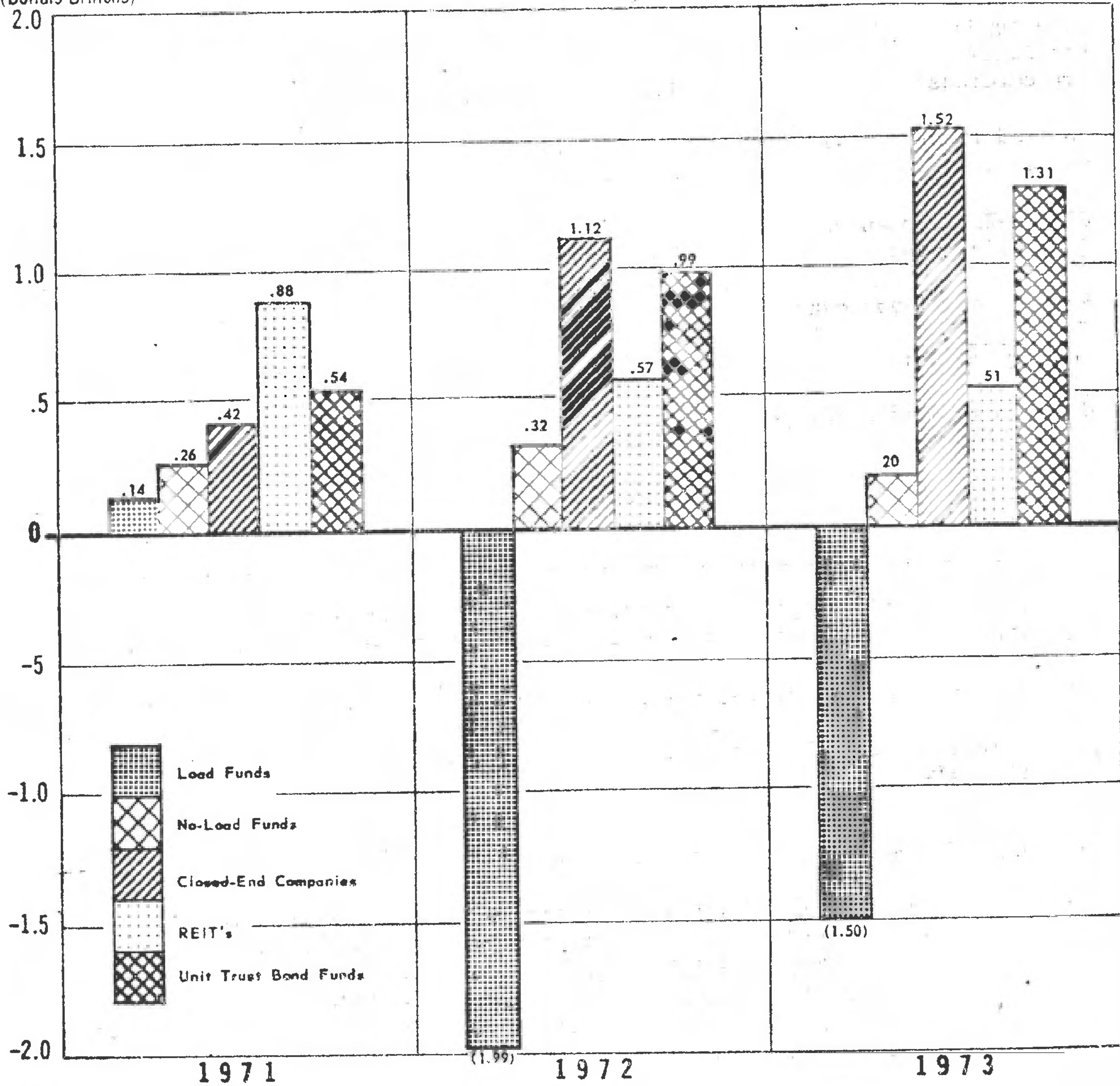
3/ Source : SEC, "Statistical Bulletin", V. 33, No. 11, p. 309 (March 13, 1974).

* Data for actual sales not available.

** Registered public offerings are primarily equity shares. At the 1973 hearings, the staff presented statistics showing REIT sales of over $1 billion for 1971 and 1972 (Tr. 13). However, those figures included sales of debt shares, which have been omitted here because REIT's normally sell debt obligations in private placements, primarily to large financial institutions.

CHART II

NET SALES (or Net Redemptions) in 1971, 1972 and 1973 of LOAD AND NO-LOAD FUNDS, AND OFFERINGS OF CLOSED-END COMPANIES, REIT'S AND UNIT TRUST BOND FUNDS



1. Sales Compensation

It is argued by one industry source that:

> "To close one's eyes to the reality of the fact that salesmen in the industry have traditionally sold products which pay the most money is to regulate without a sense of what the industry is about."1/

If this evaluation has merit, it may help explain why load fund sales have lagged, while competing products have enjoyed sales success.

It appears that in today's market, the dealer selling mutual funds often sells competing products as well, each of which offers him different amounts of compensation ranging generally from 7% on load mutual funds2/ and oil and gas drilling funds, down to a spread of 1% to 5% for secondary issues listed on exchanges and in NASDAQ. An examination of the varying levels of dealer compensation offered by competing products, as shown below in Chart III, casts some doubt on the continued validity of the finding in 1966 that the disparity between the level of compensation for selling mutual fund shares and the level of sales compensation for other securities "lead[s] securities firms and their salesmen to recommend and sell mutual fund shares rather than other shares."3/ As the Chart indicates, this disparity no longer exists. Initial offerings of closed-end investment companies generally return 6% to the dealer (and often more where there is no distributor retention).4/ Oil and gas drilling funds typically return 7% to the seller. The absence of a volume discount on some of these other new issues is also significant; it means that unlike the case of the mutual fund, the maximum charge is not reduced for larger purchases. 5/

1/ Written comment of the Seaboard Corp., File No. 4-164, p. 2.

2/ See text at p. 30 infra.

3/ Mutual Fund Report at 221.

4/ It was suggested during the hearings that compensation earned by a salesman might be doubled if he sold a closed-end bond fund rather than a mutual fund. (Tr. 40-41)

5/ The volume discount offered by mutual funds reduces the overall sales compensation by a significant amount. In 1970, the typical maximum sales charge for mutual funds was 8.5% but, largely because of the volume discount, the average sales charge for cash sales excluding reinvestment of dividends and taxable exchanges was 5.7%. NASD Study, Volume I, Summary at III-10, Table III-4.

CHART III

COMPARISON OF FEATURES OF MUTUAL FUNDS AND COMPETING PRODUCTS

INVESTMENT	RETAIL PRICE MAINTENANCE	SALES CHARGE TYPICAL MAXIMUM	UNDERWRITER'S COMPENSATION TYPICAL MAXIMUM	DEALER'S COMPENSATION TYPICAL MAXIMUM	VOLUME DISCOUNT	MANAGEMENT FEE TYPICAL MAXIMUM	LIQUIDATION (VALUE)	TOTAL AVAILABLE ISSUES	OTHER SIGNIFICANT FEATURES
							DIVERSIFIED PORTFOLIOS		
Load Mutual Funds	Yes	8.5% 1/	1.5% 1/	7% 1/	Yes	.5% Annual 2/	Net Asset Value	505 3/	Professional management, diversification of investment, broad spectrum of vehicles to choose from, redeemable. Sales reciprocals prohibited.
No Load Funds	Yes	None	None	None	N/A	.5% Annual 2/	Net Asset Value	231 3/	Same as mutual funds but no sales commission. No-loads now account for 19% of all fund sales. Sales reciprocals prohibited.
Closed-End Investment Companies	Yes (On Original Offering)	8% Initially 4/	2% Initially 4/	6% 4/	No	.5% Annual 4/	Market Less Brokerage	201 3/	Majority now trading at a discount from net asset value. Cannot be redeemed at N.A.V. Professional management, diversification, broad spectrum of investment objectives to choose from. Bond funds now accounting for majority of new offerings. Sales reciprocals permitted.
Unit Trust Bond Funds	Yes	4.0% 5/	4.0% (Generally Sold by Underwriter) 5/	2.5% 5/ (When sold by Dealers)	No	.1% Annual 5/	Unit Value Based On Portfolio Bid Value 5/	46 6/	Tax-exempt municipal bond fund units usually sold in series. High yield, minimal risk. Uses sales reciprocals. Sponsors generally maintain a market by offering to repurchase shares. Otherwise, they may be redeemed.
Real Estate Investment Trusts	Yes (On Original Offering) 7/	8.0% 8/	3.25% 9/	4.75% 9/	No	1.0 - 1.2% Annual 10/	Market Less Brokerage 11/	193 12/	High yield with possible high risk, professional management, diversification of holdings in real estate investments. Indirectly, offers tax advangages of real estate.
Oil and Gas Drilling Funds 13/	Yes	8.0%	1%	7%	No	8.0 - 10.0%	Limited Ability to Liquidate	109	High risk tax sheltered investment with deduction against gross income; oil depletion allowance; illiquid investment.
Mini Accounts	N/A	None	N/A	N/A	N/A 14/	2% Annual 15/	Market Less Brokerage	71 Firms Responding to Staff Questionnaire Showed 23,733 Accounts 16/	Professional management; may offer diversification of investment, individually tailored portfolio, direct ownership. Uses sales reciprocals.
							INDIVIDUAL SECURITIES		
New Issues	Yes	2.8% - 13.3% 17/ (Spread)	N/A	N/A	No	N/A	Market Less Brokerage	3,285 Filed No Accurate Figure on Amount Sold 18/	Degree of risk varies depending on underlying company.
Secondary Market	Competitive Rates Being Instituted	1 - 5% 19/ (Spread)	N/A	1 - 5% 19/ (Spread)	Yes	N/A	Market Less Brokerage	9,285 20/	Degree of risk varies depending on underlying company.
Savings Institutions	N/A	None	N/A	N/A	N/A	N/A	Net Asset Value Plus	N/A	Virtually no risk. Higher yield has made savings more attractive than in past relative to other investments. Greater return available for larger amounts.
Debt Instruments	Yes (On new issues) No (In secondary markets)	0 - 4% 21/	N/A	N/A	No	N/A	Varied	Not Available	Varying degrees of default risk ranging from none on many types of government-backed instruments to considerable risk on some corporate bonds. Some issues offer tax advantages and relatively high yields.

FOOTNOTES TO CHART III

1/ NASD Study, Vol. I, Summary, at III-59.

2/ Based upon data from selected prospectuses. It should be noted that although the typical maximum management fee is 0.5% for both load funds and no-load funds, load funds had a 1970 weighted expense ratio of 0.54% of total assets against a corresponding expense ratio of 0.72% for the no-loads and low-loads. (OER Report, Part I, at A-95).

3/ 1973 Securities and Exchange Commission Annual Report, at 149. Figures for load funds exclude 52 variable annuity separate accounts.

4/ Based upon data from prospectuses of selected closed-end investment companies.

5/ Based upon data from prospectuses of selected unit trust bond funds.

6/ Based upon registrations effective during 1973.

7/ SEC, "The Emergence of the Real Estate Investment Trust Industry" ("REIT Study"), April 1973, at 8.

8/ Id., at 25. Based upon a study by the SEC Office of Economic Research of new offerings during 1971. The spread on equity was dependent to a large extent upon the size of the issue and ranged from 5% to 10% on individual issues.

9/ Estimate by Kenneth D. Campbell, author of The Real Estate Trusts: America's Newest Billionaires (1971). (Staff telephone inquiry, June 26, 1974).

10/ REIT Study, at 39, and Campbell, The Real Estate Trusts: America's Newest Billionaires, at 135.

11/ REIT Study, at 8.

12/ Id., at 3. There are also numerous intrastate REIT's for which no information is available.

13/ Source: SEC registrations effective during 1973.

14/ SEC, "Tabulation and Analysis of Questionnaire on Small Account Investment Management Services" (May 11, 1973), at 8. A minority of firms bunch orders of their clients affording some savings in brokerage costs.

15/ Average fees range from 5.3% at $5,000 under management to 1.2% at $200,000 managed (Id., Table IXa, p. 8). The average account size is $38,505 and the median is $29,000 (Id., at 4). A fee of greater than 2% is higher than that normally charged, and the staff has taken the position that any adviser charging such higher fee may violate the antifraud provisions of the Investment Advisers Act unless he makes adequate disclosure to existing and potential clients. See, e.g., **Steve Stein, CCH Fed Sec.** L. Rep. para. 79,663 /current binder/ (1974).

16/ Id., Table IIa, p. 1.

17/ Based upon a yet unpublished SEC study of all registrations effective during 1971 and 1972. The average spread of common stock primary offerings was 9.39%, but such factors as the size of the issue, degree of risk and tenor of the market minimize the importance of an average. The spread cited may have widened during 1973. Most sales efforts were limited to the underwriting syndicates.

18/ 1973 Securities and Exchange Commission Annual Report at 163.

19/ The typical maximum commissions for exchange listed stocks is spread between 1% and 4% (see NYSE Constitution, Art. XV at §1702) but has been noted above as 1% - 5% to include over-the-counter securities which fall under the so-called 5% mark-up policy. (See **NASD Manual, Rules of Fair Practice, Art. III,** Section 4, Paragraph 2154). The NASD Study (at III-49) noted that the average size mutual fund sale transaction was about $2,900 in 1970. Applying NYSE minimum commission rates to a similar size sale of common stock (assuming a round lot order) would result in a commission of about 1.8%.

20/ Based upon 6,353 issues as the unduplicated count of securities on exchanges (1973 Securities and Exchange Commission Annual Report, at 162) and 2,932 issues quoted on NASDAQ on December 31, 1973 (1973 NASD Annual Report, at 10).

21/ Generally no sales charge on governmental issues. An SEC study of all corporate registrations effective during 1971 and 1972 showed an average spread of 1.14% with a range from 0.83% to 4.02%. (See footnote 17, above).

Furthermore, to the extent that the abolition of give-ups and the adoption of the NASD's rule prohibiting sales reciprocity arrangements affect dealer compensation, there is at least an implication that the relative selling compensation received by mutual fund retailers has been reduced even further than an examination of maximum dealer concessions would indicate. Thus, the prohibition of give-ups and sales reciprocals since the writing of the 1966 Report can be viewed as making fund sales less remunerative in an absolute sense and, in the case of sales reciprocals, in a relative sense vis-a-vis certain competing products with respect to which sales reciprocals have yet to be prohibited (See Chart III). As is discussed at pages 34-36 infra, the outlook suggests continued reduction of compensation opportunities derived from the sale of fund shares.

To further tip the scales away from the situation in 1966, participants in the hearings maintained that many competing products which offer competitive or, in some cases, more favorable compensation are now easier to sell. While the NASD Study found that the average time required to complete a mutual fund sale was greater than for a common stock sale, 1/ and the Study did not consider the time involved in selling such products as REIT's or closed-end bond funds, testimony revealed that these products are often sold over the telephone. Also, the existence of a closing date on a new offering, a factor generally not present in the case of an open-end fund, tends to reduce the sales effort required since it compels an investor to make a quick decision. 2/

2. A Shift in Investor Interest

As Chart III indicates, the investor today has a large variety of financial products from which to select, each with its own combination of special features. From the standpoint of an investor appraising these different investment media, two of the most critical considerations are anticipated return and degree of risk. It may well be that many mutual funds are now perceived by investors as offering low dividend

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1/ The longer time was reported to be in part attributable to the difficulties of explaining mutual funds, which salesmen consider more complex than some of the competing products they sell.

2/ Tr. 41-42.

yields while at the same time being subject to the risks inherent in the market.1/

It is possible that the disappointing performance of the equity markets and the current extended era of increasing interest rates have turned many prospective mutual fund owners to other more secure products. Debt instruments are now offering relatively high yields and in many cases are risk free or present considerably lower risks than those found in the equity markets. Consequently, investors have turned in significant numbers to unit trust bond funds, closed-end investment companies specializing in bonds, and the more recent cash management funds.

Aside from the likelihood that some potential fund investors have turned to competing products because of the more appealing investment characteristics they offer, it may be that the funds have lost some potential customers due to investor mistrust or misunderstanding of the mutual fund investment concept. A Louis Harris poll indicated that in the public's eyes, mutual funds trail such investment media as bonds, stocks and savings accounts in categories ranging from liquidity appeal to "best for growth" and "best protection from inflation."2/ Another study of the public's views on investment conducted for the Securities Industry Association showed a similarly low esteem for mutual funds in comparison with other vehicles competing for savings dollars.3/

1/ Of course, many competing products, despite their relatively large sales in recent years, also involve risks. With only a few exceptions, closed-end investment companies, including "bond funds," are now selling at a discount from net asset value. REIT's, as recent events indicate (see Greer, Realty Investment Trusts Again Falling by Wayside, The Washington Post, June 24, 1974, p. D-11 and Metz, Market Place: REIT's Suffer As Rates Soar, The New York Times, July 5, 1974, p. 32), may involve considerable risk **and have fallen from investors' favor.**

2/ Harris, Building Public Confidence in Financial Institutions in the Seventies, FINANCIAL ANALYSIS J. Mar-April 1973 at 24, 26.

3/ OPINION RESEARCH CORP., THE PUBLIC AND INVESTORS EVALUATE THE SECURITIES INDUSTRY (1972).

3. Another Recent Competitive Development - Diversification of Fund Managers

A decade ago fund managers, for the most part, were only that. Perhaps some were also investment counselors or broker-dealers whose fund activities were a natural adjunct to their other business. In contrast, many fund management companies today are part of a much larger, broadly diversified complex of financial holding companies, insurance companies, or even major conglomerates, often publicly held. This trend to diversification is also apparent at the level of the investment adviser itself. Besides serving their mutual funds, advisers today also provide a host of other money management products, including traditional private counselling, so called mini-accounts, investment advisory subscription services, unit trust bond funds and closed-end income or venture capital companies, real estate syndications and other tax sheltered programs and variable annuities, and, in the future, variable life insurance.

It is hard to say whether competition with other products has forced the industry to diversify or whether diversification created the competition, but it is clear that diversification is a fact of life for the mutual fund industry. Donald Pitti, of Wiesenberger Services, presented this view of the situation:

> "The immediate result of this increasing commitment that we see to the integrated selling of different kinds of financial products is that, realize it or not, like it or not, we are in the midst of a new kind of marketing battle for the consumer's financial services dollar. Unlike the railroads, who never understood that they were really in the transportation business, financial service executives must realize that they are no longer in the insurance business, the brokerage business, the banking business, or the mutual fund business; they are in the money business. The wrenching problems of negotiating commisions, mutual fund sales charges, institutional access to the major stock exchanges, and the scope of bank holding companies are only skirmishes in this bigger distribution

> battle, and the resolution of these problems will only serve to speed up the implementation of the financial services concept. These and other changes will ultimately force all the traditional sellers of single financial products into some kind of combination selling because the only way they will be able to maintain their sales thrust in the kind of competitive environment these changes will create will be to increase their marketing effectiveness while offering their services at less cost to the consumer. They are only going to be able to do that, in my opinion, by selling five products to one prospect rather than one product to five prospects."1/

Summary

It appears that mutual funds are subject to vigorous competition for the investor's dollar with different investment media, many of which offer similar features, can be more easily sold on the basis of current yield, and also offer attractive compensation to dealers and salesmen.

B. Distribution Margins Narrow for the Principal Underwriters

A key feature of the mutual fund merchandising strategy has been to offer large rewards to broker-dealers who enter into dealer agreements to distribute fund shares. Much of the reward -- the dealer discount -- derives from the sales load (typically 8.5%). Year by year the dealer's share of the sales load has risen from 4 or 5% in 1940, to in some cases, as much as 8% or 8-1/4% today -- but typically 7%. 2/ This trend has left little for the principal underwriter to finance the wholesale effort or to use for advertising or building product recognition and demand for fund shares, or providing other services. At the hearings, H. Bridgman Griswold, President of Union Service Distributor, Inc., described some of the other services performed by principal underwriters as including training salesmen, supplying prospectuses, reports, and performance guides, and assisting in closing complicated sales. 3/ Mr. Griswold commented as to the effect of this squeeze:

> "In recent years . . . [Union Service] Distributor has operated at a loss, which loss, within limits is now provided for by the investment companies in the group. This shift in operating results has taken place even though the basic sales charge was increased from seven and a half percent of the offering price to eight and a half percent in May of 1970. It results primarily from the substantial reduction in the sales charge actually realized by Distributor, reflecting cumulative discounts, etc., and increased distributing costs of personnel, materials and services." 4/

1/ Tr. 2363-64.

2/ Based upon 1971 N1-R reports. As recently as 1966, the typical discount was still 6-1/2%. Mutual Fund Report at 207.

3/ Tr. 2209-10.

4/ Tr. 1822.

The notion of a distribution system which is, in itself, not profitable seems to have become accepted as a fact of life by the mutual fund industry, and more and more complexes have been forced to finance essential wholesaling services and the sale of fund shares out of the profits generated from investment advisory fees:

> "The economics of this business is such that distribution is not a means of making a profit, not to a company such as IDS nor to most underwriters in this business. It is really an adjunct or a method of marketing your money management services for which you charge and out of which you make a profit . . . .
>
> "Our distribution organization is essentially nothing but a mechanism by which to market those services out of which we make a profit to bring the money into the house. * * *"1/

Indeed, some fund complexes have from time to time offered dealers the <u>entire sales load</u> on certain of their funds. As an example, Putnam Management Company advertised such an offer to dealers with regard to The Putnam Income Fund from January 15, 1974 to March 14, 1974 in the following manner:

1/ Testimony of Robert M. Loeffler, on behalf of Investors Diversified Services, Inc., Tr. 2190-91.

In order to acquaint you with the fact that the new investment objective of **The Putnam Income Fund** is "high current income consistent with prudent risk," and to encourage renewed activity on your part in this fund, Putnam Fund Distributors, for a limited time, **offers you the full commission** together with the necessary sales support, including direct mail, to help you take advantage of this opportunity.

But note that this special arrangement is available only during the early part of 1974, **between now and March 15.** For full information, call your Putnam representative or write:

PUTNAM FUNDS

Putnam Fund Distributors,
265 Franklin Street,
Boston, Mass. 02110
(617) 423-4960
West of Mississippi: (800) 225-1581

Paying the entire sales load to dealers apparently resulted in a marked increased in sales of The Putnam Income Fund's shares during the period of the special offer. Sales of the fund during that 2-month period amounted to $5 million, compared with slightly more than $3 million <u>for all of 1973</u> and $680,000 for the first quarter of 1973. 1/ Moreover, the fund's improved sales did not end at the conclusion of the special offer. For the four weeks following March 15, the fund recorded sales of $1,110,000, this was nearly double its sales for all of March and April, 1973. 2/

The willingness of major fund complexes such as this one 3/ to forego any share of the selling compensation of one of its mutual funds, albeit for a limited period of time, dramatically underscores the fact that fund sponsors may regard the underwriter's spread as negotiable and look instead to advisory fees; rather than distribution profits, for their compensation.

C. A New Road to Market

1. NYSE Member Firms - "We Could Do without" the Funds

One of the most significant findings of the OER Study was that the fund industry over the past decade has come to rely more and more heavily on large broker-dealers -- NYSE member firms -- for the bulk of its gross sales. The ICI estimates that, before 1960, approximately 65% of distribution through independent broker-dealers was accounted for by non-members of the New York Stock Exchange; whereas, now this balance has been reversed and about 65% of broker-dealer sales are presently accounted for by exchange members. 4/ However, mutual fund retailing does not represent a particularly important part of NYSE member firms' total

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1/ Letter to staff from Lynford M. Richardson, Controller, Putnam Management Company, April 19, 1974.

2/ *Ibid.*

3/ As of June 30, 1973, the total assets of all the mutual funds in the Putnam complex were approximately $1.96 billion, of which the Putnam Income Fund represented some $131.6 million. SEC, Classification, Assets and Location of Registered Investment Companies under the Investment Company Act of 1940 as of June 30, 1973, at 17.

4/ ICI comment, at 23. On the other hand, it might be noted that slightly more than two-thirds of the <u>revenues earned</u> through retailing investment company securities in 1970 went to non-exchange firms, including captives. OER report, at A-28, n. 2. But this percentage also seems to be declining; in 1971 the portion of such revenues which went to exchange firms had risen to 42%. Office of Economic Research. "Broker-Dealer Community: Historic Trends in Current Financial Structure," March, 1973 at 52.

revenues: only 1.6% of exchange firms' total gross revenue in 1970. 1/

The relative unimportance -- from a monetary standpoint -- of mutual fund sales to exchange firms was pointed up in the testimony of Bradley Baker, President of the National Mutual Fund Managers Association, a group of mutual fund sales managers of member firms. Mr. Baker, while praising the mutual fund as "the finest single product ever devised by the investment community for John Q. Public," nevertheless stated that, looking at the contribution of mutual fund sales to total revenues, member firms "could do without them:"

> "Member firms are important to the mutual fund industry as they account for a very large portion of the total mutual fund sales. However, mutual fund commissions are not of too great importance to member firms as they account on average per firm for only three percent of member firms' total income. What I am implying is that if mutual funds were deleted from our product mix, we could do without them."2/

Another problem for existing funds is that a number of member firms which formerly accounted for a large volume of fund sales have collapsed. Also, of those which remain, Merrill Lynch, Pierce, Fenner & Smith, Inc., which has in the past accounted for large fund sales, has organized its own fund. 3/

Yet another problem facing funds who rely on NYSE member firms for sales is that the introduction of fully-negotiated stock exchange commission rates for portfolio securities may well have a further dampening effect upon the marketing of mutual fund shares. As indicated at p. 8 above, the Commission recognized in the Letter of Transmittal of its 1971 Institutional Investor Study Report, that to the extent the elimination of fixed minimum rates cuts off an important source of income for selling fund shares and fund distribution methods continue unchanged, the direct charges for selling funds would have to be increased or mutual fund distribution would be decreased.4/

1/ OER Report, at A-27 to A-28. Of course, 1970 was a depressed year for mutual fund retailing. However, while revenue from mutual fund retailing made a somewhat larger contribution to aggregate NYSE member firms' gross income in earlier years, it has never been a really substantial factor.

2/ Tr. 1022-23.

3/ Lionel D. Edie Capital Fund. Of additional significance is the fact that Merrill Lynch is marketing this fund with a 6.5% maximum sales load, i.e., more than 20% less than the 8.5% maximum typical of the industry, and a maximum dealer discount of 6%. During the first weeks of its initial public offering late in 1973, the fund had sales of some $225 million. However, sales dropped sharply after this initial success; as of March 31, 1974, the fund's total sales had risen to only $230.5 million and net sales were $225.6 million. (Data based on Staff inquiry).

3/ Institutional Investor Study Report, Part 8 at xix.

It is of course true that negotiated rates already prevail for sales under $2,000 and for that portion of any sale in excess of $300,000 and, to this extent, the marketing of fund shares already may have been affected. However, the full impact of reduced brokerage costs will not be felt until fully negotiated rates take effect across the board. Presently, brokerage houses can continue to receive fixed-rate patronage from the funds so long as such patronage is not given in return for sales of fund shares.1/ Consequently, some profits from fixed-rate transactions performed for funds are still available for those who sell fund shares, even though reciprocity as such is not allowed. Thus, although reciprocal brokerage is no longer permitted to be used as an incentive to market fund shares, a broker-dealer receiving fund brokerage at non-negotiated rates (on orders, or portions of orders, less than $300,000) can view the profits of such business as a supplement to the profits realized directly from the sale of fund shares. But when fully-negotiated rates take effect, the remaining "fat" arising from portfolio transactions should be gone.

Another result of fully-negotiated rates should be the "unbundling" of brokerage services. That is, brokers will likely begin imposing separate charges for various services which were previously performed at no extra charge -- or not offering the services at all -- because their cost was included within the fixed sales commission. In some cases, this has already begun.2/ As both broker-dealers and customers begin to view such separate charges as a usual way of doing business, it is to be expected that broker-dealers will wish to impose -- and customers may be willing to accept -- separate charges for various services rendered in connection with sales of fund shares, which are now covered by the fixed sales load. Thus, if viewed as separate from an original

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1/ That is, under the NASD rule, sales of fund shares by a particular brokerage house can be neither a qualifying nor a disqualifying factor for the receipt of brokerage business from the fund. Thus, a fund may continue to direct fixed-rate (and thus highly profitable) business to a broker which sells its shares, provided that the fund's choice of that broker does not interfere with the fund receiving best price and execution and can be justified on some other ground e.g., the broker's professional capability or thorough research.

2/ For example, Merrill Lynch offers a "Sharebuilder Plan" account for small investors, with commission charges 16-24% less than the old rates for orders under $2,000. However, investors taking advantage of such discounts must sacrifice certain services which they would otherwise have received. Specifically, they must transmit all orders to buy or sell through the mail, with no telephone orders being accepted; moreover, any subscription rights for additional shares may not be exercised, but are instead automatically sold by Merrill Lynch on behalf of the customer. In addition, certificates, which would otherwise be sent to the investor, are held by the firm unless the customer pays a separate transfer charge for having them sent to him.

purchase, services rendered by fund dealers could tend to undergo the same "unbundling" as services associated with sales of other securities.1/

Summary:

It appears that, as long as the funds remain largely dependent upon NYSE member firms and those firms can afford to be indifferent in their efforts to sell fund shares, the outlook for improvement in the merchandizing of fund shares will be, at best, uncertain.

2. Small Broker-Dealers Taken for Granted or Cut Off

The funds have not strengthened their relationships with small broker dealers to compensate for the growing indifference of member firms. Mutual fund retailing is considerably more significant to non-NYSE firms than it is to exchange members. Non-members received approximately 11.6 percent of their total gross revenue from this source in 1970. 2/ Moreover, the ICI points out that the non-exchange broker, by virtue of his very lack of exchange membership, has a limited line of financial products to offer, and thus has a great incentive to be "loyal" to mutual fund retailing. 3/ In 1970, according to the ICI, 182 non-NYSE firms obtained 90 percent of their gross income from the sale of mutual funds. However, this only serves to demonstrate that, as the Commission noted in the letter of

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1/ Although the term "unbundling" is generally used with respect to secondary market transactions and mutual fund shares are sold in a nominally primary offering, their distribution is quite analogous to secondary market transactions in other securities. A mutual fund primary offering is continuous; there is no need for an underwriter to guarantee, or even attempt, the sale of a given number of shares within a fixed period of time. Furthermore, unlike other securities in a primary offering, the price of mutual fund shares does not, and cannot remain, fixed; it varies with net asset value. Hence, only that portion of a fund share's price which is designed to cover selling services remains fixed. Section 22(d) precludes dealers from unbundling these services -- and the charges for them -- to the same extent that brokers of other securities unbundle their services and charges.

2/ OER Report, at A-28.

3/ ICI comment, at 23.

transmittal accompanying the OER Report, "the mutual fund industry is far more important to these firms than they are to it." 1/

At the hearings, small broker-dealers complained of receiving little assistance from fund wholesalers, 2/ and that fund underwriters have organized their own captive sales forces 3/ thus cutting off the broker-dealers. The testimony of Robert Roth of Mark Securities, an over-the-counter dealer in Hartford, Connecticut, suggests the flavor of what can happen:

> "We have had one large case where a certain fund decided to eliminate 1,500 dealers, take our commissions, use it to finance their own captive organization. With it, probably, I would say from our sales in firms that we took over represented $4 to $5 to $8 million of their fund, a lot on voluntary sales where we completely lost that commission.
>
> "They in turn had our accounts, had the names, I am sure, and I am not going to get into this area, that they then sent those customers to their own captive organization, and we had absolutely no recourse, and I don't even want to think about how much money we lost on this situation." 4/

Another bone of contention has been the minimum dealer allotment on sales loads for dividend reinvestments. That is, where a sales load is charged on reinvestment of income dividends, dealers receive a portion of the sales load (*i.e.*, the dealer discount) on the reinvestment. Certain fund principal underwriters which had previously remitted all such dealer discounts, or at least all amounting to not less than $1 per quarter for each account, have more recently held back the dealer discount on accounts for which the dealer's

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1/ OER Report at iv-v.

2/ Tr. 935-36.

3/ Keystone Custodian Fund, Inc., of Boston for example, has established its own direct selling organization. Tr. 309. That is not to say, however, that the captive sales force will be the wave of the future. Massachusetts Financial Services, for example, moved in the opposite direction when it terminated distribution of its family of funds and set out to build an independent dealer network with its "go for broker" campaign.

4/ Tr. 936

portion totaled less than $5 per quarter. 1/

For some dealers, loss of this commission income has been significant, and at least two separate complaints have been filed with the NASD against various underwriters with regard to the practice of raising the minimum amount on which the dealer discount would be paid on dividend reinvestments. 2/ In both cases, the complaints were dismissed by the NASD's Board of Governors, and the Commission declined to review the dismissals.

Mr. Roth left little doubt as to how he felt about the $5 minimum payment rule:

> "* * * /F/rom a little fund the commission was $4.65, that is below the minimum amount, they are not going to pay it.
>
> "I have to pay my salesmen, but they decide that is too small an amount. Sure, if I had known this was going to happen, we should have negotiated a contract, and I doubt we would have sold any of the funds. But they are all standard contracts, as far as I know.* * *"3/

1/ The institution of the $5 minimum appears to have been based partly upon a desire to decrease the cost of handling and distributing these commissions to investment dealers by minimizing paperwork, and partly to offset increased dealers' discounts on new sales instituted in response to competitive pressure. See testimony of Robert Riley, President of Putnam Management Company, Tr. 229.

2/ Wurzburger, Morrow & Keough, Inc. v. Putnam Fund Distributors, Inc. and Vance, Sanders & Co., Inc., Complaint No. B-268, District 13, filed June 19, 1971; and James M. Smith d/b/a J.M. Smith & Company v. The Keystone Company of Boston, complaint No. B-277, District 13, filed July 29, 1971.

3/ Tr. 938-39.

D. Facing Up to Investor Skepticism

It has already been noted that surveys of investor sentiment have indicated what may be taken as a misunderstanding of the mutual fund form of investment. While the existence and extent of any investor confusion is speculative, if the phenomenon is real it may have its roots in two occurrences in certain fund industry quarters during the 1960's. The first matter relates to the so-called "go-go" boom of the late 1960's; the second pertains to the failure of some funds properly to service their shareholders.

1. "Reaping the Bitter Harvest"

Mutual funds have established themselves as investment programs which are designed for the long term. Nevertheless, attracted by spectacular short term investment results of the so called "go-go" funds and the glamorous reputations of their managers, large numbers of investors bought funds in the late 60's in hopes of quick success. Some of the best selling funds, many of them operated by newcomers to the business but a number of them also organized and promoted by the older more established management organizations, followed the then popular trends and employed a number of speculative devices -- high portfolio turnover, leverage, and purchases of restricted securities, options, new issues and stocks with very thin floats -- in the hopes of achieving dramatic success. As a result, when the stock market declined, many of those highly volatile funds which had climbed faster than the market, declined equally as fast. These funds conveyed an impression of mutual funds as a short-term, speculative, high risk investment -- a far cry from the program upon which the fund industry had been built. 1/ This phenomenon was described by Roger McCollester who was the partner at W.E. Hutton & Co. in charge of its mutual fund sales:

1/ Tr. 2399. Mr. Pitti stated at the hearings:

"The 1967, '68, '69 boom in interest in mutual funds I think was an extension of that concern about inflation and ... a revival of what happens in every speculative boom. The greed and fear of people wanting to make money when everybody else is. And I think that at that time, although we all know that the funds contributed a great deal to the problems that ... developed ..., I think the funds were the victim of that greed and fear in the late '60's. I think the public in a collective sense and in an amorphous sense decided that that was a horse to ride at this time.

"I'm 43 years old and I have been through three market cycles and I have seen it happen and I know it will happen again. The next time we get into a speculative boom some other investment medium will be singled out as the horse to ride this time.

"And then we had the ... disenchantment that always comes after a speculative blow-off, and the funds now are reaping the bitter harvest, I think mainly because the industry was not mature enough and sophisticated enough to withstand the temptation that was afforded by this thirst that cried to be satisfied." Tr. 2398-99.

"We only have to go back to the 'go-go' era when people were buying the portfolio managers of their choice, their track records, and in those days you couldn't give enough away, if you will. --- [I]t was sold as a stock, but didn't that come back to haunt the salesman who did it, because in effect he was doing it for the wrong reason. He was selling an individual the aura of his performance and was not following what all of us here believe to be the proper method of offering, a concept -- a long-term investment concept. He was selling a short-term quick appreciation to a hungry guy who wanted to make a buck fast, and who found that his own trading account wasn't doing as well as Mr. XYZ's or Mr. ABC's. We all know the names." 1/

In addition, many of the funds whose sales suddenly increased during this era, and their transfer agents, were ill-equipped to cope with success. 2/ Their back-office staffs were overwhelmed with paperwork. The chaotic effect upon investors and retailers was well described by Orville H. Lauver, an independent broker-dealer from York, Pennsylvania:

"Have you ever had problems with your checking account, with the bank coming back with a different balance? Can you imagine an individual who doesn't understand in depth as much as perhaps we would like them to understand, and then getting a statement where they see shares being taken away or not credited to their account. You know, that is a nightmare. It took us a year and a half of correspondence." 3/

The excesses of the 'go-go' funds tended to spill over onto the more conservative funds which avoided sudden declines in value and serious back-office problems. This is suggested by a comment of John Weller, an independent broker-dealer from Camden, New Jersey:

"[Y]ou have two funds that a person might be going into. And if one creates a tremendous amount of headache for the client, they tend to get leery about the other one. This is one of the problems." 4/

1/ Tr. 1071-72.

2/ As one illustration of the problems that arose where there was such a paperwork crunch, on February 27, 1970, the Commission announced (Litigation Release No. 4547) the resolution of an action involving Enterprise Fund, Inc., in which the Commission alleged, among other things, that on January 14, 1970, 853,000 of the Fund's approximately 95 million outstanding shares were not posted to shareholder accounts.

3/ Tr. 877. These problems still occur. On April 24, 1974, International Investors Incorporated voluntarily suspended sales because it was experiencing a major back-office problem. Sales were resumed on June 17, 1974.

4/ Tr. 877.

2. Shareholder Service

While some investors may have experienced frustration over back-office chaos, others experienced inadequate or nonexistent salesman follow-up after the sales presentation.

George Washburn, Vice President in charge of fund sales for Reynolds and Co., testified:

> "Right now we get very little continuing service after a fund sale. Even people who still have on their, say, dividend reinvestment notice both a dealer and a salesman, there is very little service being done two or three years, five years down the pike in helping a person understand and evaluate what he owns." 1/

Mr. Washburn later added that:

> "I would say there is a large portion of the say five or six million fund holders we have are not getting the service they need, if not getting none at all. All of us have experience of contacting and running into people who have had a fund for 5, 10 years and they never heard from the salesman that sold it to them. And I know many of the funds have large blocks of what they call orphan accounts." 2/

E. The Shift to Big Ticket Investors

Historically the funds' most important market has been the small investor. Funds have provided a valuable service for such investors who otherwise might not be able to afford professional management and a share in a portfolio of a large number of listed securities. However, the trend over the last decade has been toward larger sales. In 1960 sales of $25,000 and over accounted for 20% of total load fund sales volume. 3/ By 1970 sales of $25,000 or more

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1/ Tr. 1117.

2/ Tr. 1128.

3/ NASD Study, Table III-6, at III-14.

accounted for 34% of total load fund volume 1/ and by 1972 they were 52%. 2/ Even more dramatic evidence of the changing relationship between the fund industry and small investors can be found in the fact that about 80% of the fund sales of the last quarter of 1972 by Merrill Lynch, Pierce, Fenner & Smith were in amounts of $25,000 or more and nearly 60% were in amounts of $100,000 or more.3/

Roger McCollester placed the following interpretation on this kind of data:

> "I think what it means is . . . two things. I think that obviously mutual funds for many good reasons are attractive to the large investor maybe even more so to him with his sophistication and his knowledge that he needs professional management . . . .
>
> "I think that it is also an evidence of the fact that the salesmen of our firms are definitely concentrating on the big ticket through installment sale purchases . . . . I think the sophisticated dollar is a more attractive dollar for a salesman with the amount of time he has available to offer his services, and I think it is also evidence of the fact that we are not scratching the surface of the small investor as well as we should. And yet he is the guy who probably needs our help more than anybody.4/

1/ NASD Study, Table III-6, at III-14.

2/ Written comment of W.E. Hutton & Co., File No. 4-164, p. 3. While inflation may have had a hand in the increase in larger sales, it does not appear that inflation alone explains the phenomenon. The 1966 Report, relying on ICI data, pointed to a figure of $1240 as representing a typical mutual fund purchase in 1966. See Mutual Fund Report pp. 206-207 and fn. 20, 21. The NASD Study reported that in 1970 the average size fund sales transaction was about $2,900 according to questioned broker-dealers. NASD Study, III-49.

3/ Testimony of Robert Cleary, Vice President of Merrill Lynch, Tr. 256. According to the NASD, sales of $1 million or more accounted for 8.2% of the volume of load funds' cash sales in 1970. This contrasts with a 1/10 of 1% figure for such sales in 1960. NASD Study, Table III-6, at III-14.

4/ Tr. 1033-34. On the other hand, we would point out that a large number of small shareholders is not an unmixed blessing for a fund, in view of the relatively high cost of servicing small accounts. The difficulty is compounded where state expense limitations force the fund's management to choose between providing limited service or returning a portion of its fee to keep the fund's expenses within the prescribed limits.

SUMMARY:

The mutual fund distribution system is being influenced by forces over which it has little or no control. Other investment products compete aggressively to meet present-day investors' demand for high yield and relative safety of principal. At the same time, retailers who distribute such competing products can realize compensation comparable or even superior to that which could be earned by selling funds. Further, the fund industry's ability to retain the loyalty of retailers becomes more uncertain as the percentage of fund sales made by large broker-dealer firms, to whom such sales are a relatively unimportant source of income, rises. As if these difficulties were not enough, the fund industry must also cope with the fact that the public appears still sensitive to the sudden declines in value in some funds, and the back-office problems of others, which resulted from the excesses of the "go-go" era of the 1960's.

In response to this combination of forces, fund underwriters have surrendered greater portions of sales commissions to dealers, to the point that underwriting profits have all but disappeared. More than ever, fund advisers are subsidizing distribution out of advisory profits. Perhaps for this reason, with small broker-dealers accounting for fewer fund sales, some in the industry have allowed their relationships with such retailers to deteriorate. Moreover, the fund industry seems to be unable to assure proper follow-up service to shareholders. Whether as a result of these factors or of the condition of the market in general, funds have lost ground with their traditional best customer, the small investor; a rising percentage of fund sales are in large amounts.

In other words, the industry is not prospering with the marketing strategy which was so successful in past years. Hence, changes in the pattern of fund distribution seem inevitable, particularly as changes in brokerage practices might cause more investors and broker-dealers to begin to look upon an expensive "bundle" of selling services as unnecessary and obsolete.

III. Regulation of Fund Sales Under Section 22(d) Today

A. Exemption from Section 22(d)

Section 22(d) prohibits mutual funds, underwriters, and dealers from selling fund shares to the public "except at a current public offering price described in the prospectus." In other words, the section requires retail price maintenance. However, the Commission has issued many general and individual exemptions from Section 22(d) so as to make the retail price maintenance requirement inapplicable in a wide variety of circumstances.

The broadest such exemption is Rule 22d-1 which, among other things, permits the sales load to be reduced or even eliminated where shares are purchased in large quantities, dividends or capital gains are reinvested, or shares are purchased by certain tax-exempt organizations or officers or employees of the investment company or its investment adviser or principal underwriter. A more limited general exemption from Section 22(d) is contained in the recently adopted Rule 22d-2, which permits mutual funds to allow their shareholders to reinvest without a sales load, within 30 days, the proceeds of a redemption of the fund's shares. The no-load reinvestment can be in the same fund or in a "sister" investment company offering shareholders in the former a no-load exchange privilege.

In effect, by these two rules, the Commission has dispensed with the retail price maintenance requirement where a lower price would be justified by distribution economies (in the case of Rule 22d-1), or would avoid penalizing a shareholder who has mistakenly redeemed his shares and wishes to repurchase them almost immediately (in the case of Rule 22d-2).

Further price variations beyond a single offering price have been permitted by the numerous and varied individual exemptions which have been granted from Section 22(d). These exemptions have been based upon differences in cost and service, or considerations of basic fairness, national economic policy, or sound business practice. While the individual exemptions are not easily classified, a large number of them relate to variable annuities. In this regard, the exemptions fall

mainly into four categories where a full sales effort is not required: (1) transfer of insurance proceeds or cash values to a variable annuity operated by the same company; (2) refunds of excess charges or divisible surplus in the form of variable annuity shares, in a manner similar to a dividend reinvestment plan; (3) transfer of funds from a fixed annuity separate account to a variable annuity separate account; and (4) investment by a beneficiary of life insurance proceeds in variable annuities. A number of exemptions have been granted outside the variable annuity area. Thus, the Commission has also provided exemptions relating to sales of mutual fund shares in foreign countries. Many exemptive orders have also been issued to permit the exchange of fund shares for the assets of personal holding companies. Other exemptions from Section 22(d) have been granted where the applicant has changed its method of distribution, and a failure to vary the price for certain repeat investors would result in unfairness to them.

Sales made pursuant to exemptions from Section 22(d) are a substantial part of the fund distribution picture. During 1973, gross sales of the mutual fund industry were $4.4 billion, of which $3.6 billion were made by load funds. Of the load fund sales, an estimated $1.2 billion, or approximately one-third, were made pursuant to exemptions from Section 22(d). This figure must be viewed as conservative because the data, as shown in Table II below, does not include the value of exempted sales to employees for other than the organizations 1/ queried by the staff, nor does it include sales to certain tax-exempt organizations pursuant to Rule 22d-1(e).

1/ The staff inquired of five large fund complexes. Of these, three had made no significant sales to employees pursuant exemptions from Section 22(d).

TABLE II

LOAD FUND SALES MADE PURSUANT TO EXEMPTIONS FROM SECTION 22(d) IN 1973

1973 Total Load Fund Sales (ICI Members) (mil)		$3,550.7
Load Funds' Estimated Reinvested Distributions at No-Load Pursuant to Rule 22d-1(b) and (c):		
Net Investment Income a/	$474.9	
Capital Gains b/	645.4	
	Subtotal	$1,120.3
Foreign Sales Pursuant to Exemptions from Section 22(d) by: c/		
Keystone Custodian Funds, Inc.	$ 51.6	
Investors Diversified Services, Inc.	21.6	
Capital Research & Management Co.	20.2	
Dreyfus Corporation	15.0	
	Subtotal	108.4
Estimated Value of Shares Exchanged for Personal Holding Companies Pursuant to Exemptions from Section 22(d): d/		13.2
Exempted Sales to Company Employees and Company Benefit Plans by: e/		
Investors Diversified Services, Inc.	$ 5.9	
Keystone Custodian Funds, Inc.	1.9	
	Subtotal	7.8
	TOTAL . . .	$1,249.7
		35.2%

SOURCES: Total industry sales and reinvested distributions from 1974 ICI Fact Book.

Footnotes to Table II

a/ Load funds accounted for 90.6% of the industry's total income dividend reinvestments (based upon staff inquiry of ICI). An estimated 74% of total reinvested income distributions by load funds were at net asset value, based upon 1970 data, which is the most recent available (NASD Study, Vol. I, Summary, p. III-33).

b/ This data was constructed by determining the amounts of capital gains reinvestments reported on Forms N-1R for fiscal 1973 by all no-load funds which are members of the ICI and removing that amount ($138 million) from the industry total as reported by the ICI.

c/ Exempted foreign sales based upon staff inquiries of particular companies.

d/ Represents the total of the amounts estimated in the individual notices of application.

e/ Exempted sales to company employees and company benefit plans based upon staff inquiries of particular companies.

It is important to note that the exemptions which the Commission has granted from Section 22(d) result in investors paying different sales loads for the same fund. In other words, notwithstanding Section 22(d) the Commission has permitted variations in the public offering price which result in a form of price discrimination, as long as the discrimination is not unjust. For example, under Rule 22d-1, discounts for certain tax-exempt organizations are justified by the public policy in favor of charitable and educational institutions; reduced sales loads for fund employees are based upon the importance of the fund being able to further employee incentive and goodwill. However, one of the most important justifications for price discrimination is differences in cost and service.

B. Anomalies Resulting from Section 22(d)

Although a sales load is intended to pay for various selling services provided to investors, it is not uncommon for customers to be forced to pay sales charges even where little or no service is in fact provided. The imposition of a sales load under such circumstances is not necessarily due to a conscious decision or motivation on the part of underwriters and dealers; it is required by Section 22(d), as presently interpreted and applied.

1. "Orphaned" Accounts

An "orphaned" customer is one who owns fund shares purchased from a dealer who is no longer available, usually because he has gone out of business. If such a customer buys additional shares of the fund under an accumulation plan, he must frequently pay a sales load to a broker-dealer with whom he has had no contact. Dr. Robert Perez, a vice president of F. Eberstadt & Co.'s management and distribution companies as well as its two funds, testified as follows concerning his company's practice in this regard:

STAFF QUESTION: "Under present practices what do you do with an investor whose dealer has gone out of business, or has died, in terms of crediting sales charges on repeat investments made by the investor?"

DR PEREZ: "Well, he has to get a successor broker-dealer."

STAFF QUESTION: "How does he do this?"

DR. PEREZ: "Well, if he wishes to make another purchase he will perhaps send a check to our transfer agent Bradford who at that point will advise him that the broker-dealer that he had been using is no longer in business, no longer has an effective sales agreement with the fund, and that he should seek out another. . . . dealer, and if they wish to get our assistance in directing them to a dealer we will be glad to do so." 1/

2. Investors Who Select Funds on Their Own.

Another example of a customer having to pay an essentially gratuitous sales load is found in a letter to the editor of Fundscope magazine, which appeared in the November, 1973 issue at p. 2. The reader wrote:

> "I currently own four mutual funds, three of which I started after studying the information in Fundscope. Although these three funds, Over-The-Counter, Istel, and Vanderbilt, are 'load' funds, I purchased my shares directly from the fund. Since I did my own research and selection and did not use a broker or mutual fund representative, I would like to know what happens to the broker's share of the commission?"

In response, the editor of Fundscope explained that the reader's purchases had actually been made through the funds' underwriters, and that the latter had retained the sales commission.

Thus, where a fund "sells itself" without the intervention of a salesman, either because the fund is particularly well-known or well performing or because it has come to the attention of the customer for some other reason, the prescribed sales load must nevertheless be paid.

3. Repeat Investors.

An individual who requires the services of a salesman when he first buys mutual fund shares may, after his initial purchase, acquire sufficient sophistication to dispense with such service in connection with future purchases of the same or even a different load fund. In such a case, however, the investor must still pay the full sales load to cover a selling effort which, presumably, he no longer wants, needs or gets.

1/ Tr. 764.

An example of such a shareholder is John L. Asling, who testified at the hearings. When Mr. Asling made his first investment in a mutual fund -- Washington Mutual Investors -- in 1955, he required the services of a broker to explain:

> "basically the operation of the fund. I never knew anything about funds." 1/

However, with regard to Mr. Asling's subsequent purchases of the same fund, the broker:

> "didn't solicit me. All he had to do was pick up the phone and I said I am placing an order with you to buy X number shares of Washington Mutual Investors Fund." 2/

Yet Mr. Asling was required to pay a full sales load on these repeat orders, until:

> "after learning about the no-load funds,. . . . I really didn't buy any more shares of the Washington Mutual Investors Fund." 3/

1/ Tr. 696.

2/ Tr. 700.

3/ Tr. 701. Mr. Asling's testimony is discussed in somewhat more detail at pp. 73-75, *infra*.

IV. THE POSITIONS OF THE PARTICIPANTS IN THE PROCEEDING

A. Mutual Fund Industry Representatives

Briefly stated, the position of representatives of the mutual fund industry is that mutual funds are a good product, the distribution of which could be seriously impaired by repeal of Section 22(d). This position was articulated as follows by Robert Augenblick, President of the ICI, during the first day of the hearings:

> "[O]ur position is based on the fundamental premise that mutual funds are a sound and worthwhile medium for public investing. This is a premise which has had the approval of the investing public, the Commission and the Congress. Therefore, to our thinking it follows that those who would propose regulatory changes which would adversely affect the system of distributing mutual fund shares to the public have a heavy burden to establish that the proposal on balance will serve the public interest. In our view the SEC staff report falls woefully short of satisfying such a burden, despite its suggestion that repeal of Section 22(d) would on balance be desirable." 1/

However, although the mutual fund industry was all but unanimous in its opposition to repeal of Section 22(d), various segments of the industry did favor certain limited modifications of the present distribution system, such as increased advertising and grouping and, to a much lesser degree, even some form of price competition. Following is a representative selection of some of the views expressed by various industry representatives. 2/

1. ICI.

In its written comment, 3/ the ICI stated its belief:

> "that the repeal of Section 22(d) could be a substantial step towards disruption of the mutual fund industry. Repeal would substitute a chaotic for an orderly system of distribution of mutual fund shares, would be harmful to mutual funds and the investing public, and would ignore the lessons of pre-1940 days.

1/ Tr. 104.

2/ This section discusses some of the views expressed in the written comments and oral presentations of certain participants, in an attempt to set forth a general overview of the positions taken concerning the major issues. It is not intended as a summary of the presentations.

3/ The participants' written comments are in File No. 4-164. Except as otherwise noted, the comments were filed in advance of the hearings.

"More specifically, repeal of Section 22(d) would tend to produce the following results:

(1) The ability of mutual fund sales to keep pace with redemptions would be endangered;

(2) The redeemability feature of mutual funds would be jeopardized, as would be the availability of other important investor services;

(3) A secondary market would develop which would adversely affect mutual fund distribution without satisfactory distribution alternatives;

(4) There would be a growing trend to selling mutual funds as a speculative vehicle;

(5) There would be pressure not to comply with standards of suitability;

(6) Programs for training mutual fund salesmen would suffer for lack of available financial support;

(7) Many broker-dealer firms and registered representatives would be forced to abandon the mutual fund business;

(8) Discrimination between sophisticated and unsophisticated investors would result;

(9) The availability of mutual funds to the investing public would be seriously curtailed." 1/

The ICI added that retail price maintenance is not unique to the fund industry; to the contrary, price protection is enjoyed by many financial products with which funds compete and is basic to the distribution of corporate securities in syndicated underwritings. 2/

In general, the ICI also found difficulties with the various modifications of the present distribution system suggested in Investment Company Act Release No. 7475. 3/ However, certain modifications, such as relaxation of advertising restrictions, updating of the Statement of Policy, and permitting certain groups of persons - employees of a single employer only - to take advantage of quantity discounts, might be of some value, according to the ICI. 4/

1/ ICI comment, at 5-7.

2/ Id. at 10.

3/ Id. at 54-79.

4/ Id. at 67-73, 74-76.

The ICI later filed a post-hearing memorandum, in which it concluded basically "that the overwhelming weight of the informed testimony and written submissions confirm the points expressed in our [earlier written submission]." 1/

2. Managers of Major Funds.

Both in their written submissions and oral testimony, managers of major funds generally opposed repeal of Section 22(d), mainly for the reasons articulated by the ICI. For example, Philip C. Smith, Chairman of the Board of National Securities and Research Corporation, said at the hearings:

> "We are convinced that a repeal of 22(d) at this time will mean the end of the mutual fund industry as a viable industry, though I can't give you the time frame." 2/

Consistent with the industry's oft-repeated dictum that "mutual funds are sold, not bought," Mr. Smith, while favoring liberalization of advertising rules, said that "advertising alone will not get the job done." 3/

Similarly, James D. Fullerton, Senior Vice President and director of Capital Research and Management Company, favored increased use of advertising but said that:

> "The salesman performs a valuable and essential economic function. Consequently, for the foreseeable future I see the major objective of mutual fund advertising being to make the product easier for the salesman to sell." 4/

Carl Frischling, Senior Vice President of the Channing Management Corporation, warned that if Section 22(d) were repealed and a secondary market in fund shares established, secondary dealers might accumulate large blocks of shares and then, because of market fluctuations, redeem them for reasons completely extraneous to the value of the shares. 5/ He added that:

> "The effect of lumped redemptions, especially on small and medium-sized funds, could be very substantial, and affect redeemability vis-a-vis the normal shareholder. Such redemptions could adversely affect shareholders by requiring portfolio risks and force changes in investment position and strategy which would disadvantage the fund and fund shareholders." 6/

1/ ICI post-hearing memorandum, at 1.

2/ Tr. 2123.

3/ Written comment of Philip C. Smith, at 10.

4/ Tr. 2387-88.

5/ Tr. 2135.

6/ Ibid.

Nor would restrictions on redeemability solve the problem, in Mr. Frischling's view:

> "If the Commission bars a market-making broker from redemption of fund shares, such brokers will simply lay off their shares to banks or other institutions at a quarter or half-point discount, and those banks or institutions will in turn be able to put their shares to the fund for redemption at net asset value. Such a restriction, then, is just not realistic." 1/

Mr. Frischling also urged the Commission to consider:

> "the decrease in net revenues to the fund-distributing organizations which would necessarily result from the diversion of underwriting income from fund distributors to the broker-dealer market-makers." 2/

Other adversities which Mr. Frischling saw resulting from a repeal of Section 22(d) included:

> "a substantial reduction in the number of firms selling fund shares, a resultant diversion of effort from the sale of fund shares to sales of other vehicles (stocks, REIT'S, etc.), a consequent strengthening of Exchange member firms over the generally smaller fund-selling firms, [and] the possibility of higher net redemptions. . . ." 3/

The notion that a repeal of Section 22(d) could result in the elimination of many small dealers, thus producing an undesirable concentration of fund sales in the hands of large dealers, was reflected in the written comment of the Putnam Management Company, Inc. After conceding, arguendo, the possibility that repeal of Section 22(d) would lead to reduced sales loads, they proceeded to consider the effects of such reduced sales charges:

> "There would be an adverse impact upon two classes of selling dealers; the first being those to whom mutual fund shares are a significant portion of their business and who simply cannot exist without the profits to be made on fund shares at present commission levels, and the second those brokers who provide additional services to their customers which cannot be paid for at lower commission levels. It is not enough to say that more efficient brokerage practices will result in savings to the brokers who may then pass these on in the form of lower competitive

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1/ Tr. 2135-36.

2/ Tr. 2136.

3/ Written comment of Channing Company, Inc., and Channing Management Corp., at 18.

charges, for, even if this were so, it would encourage a trend toward larger and larger dealers; we question whether this is desirable from the point of view of the industry as a whole. Concentration of economic power is seldom a desirable end and is a particularly unpleasant prospect in an industry which deals directly with so many million individual consumers who are less able to cope with the effects of such increasing concentrations than a more concentrated consumer group. More important, however, than the impact of this competition on selling dealers would be its impact on investors. Commission price competition will cause dealers' profit margins to shrink, in turn causing the quality of the sales effort to decline. Mutual funds must be sold properly if the investor is to be sold funds and programs suitable to his needs. Approximately 85% of mutual fund shares are currently sold through independent dealers; reduced commissions will force those dealers to divert to selling alternative products which will probably not be as appropriate for the small investor as mutual funds or to do a poor job of mutual fund selling. Either way, the small investor will surely lose." 1/

At the hearings, George Putnam, chairman of the company, elaborated upon the argument that, insofar as repeal of Section 22(d) might tend to concentrate fund sales among large dealers, investors would be adversely affected:

"[T]o the extent they would be large brokerage houses selling mutual funds, they would be selling them along with many other products and not by people who are specialists in mutual funds. And I think for many potential mutual fund clients, he should in his initial experience, in buying them, should be exposed to a professional expert on mutual funds." 2/

Franklin R. Johnson, Senior Vice President and General Counsel of Keystone Custodian Funds, Inc., also suggested that repeal of Section 22(d) would, in addition to causing a decline in overall sales, impose a special hardship upon small dealers:

"We cannot foresee any possible consequences of the repeal of Section 22(d) that would not result in further reductions in sales and further increases in losses or alternatively, a discontinuance of active selling efforts to reduce losses. It is our experience and common knowledge that mutual fund shares are on the whole sold and not bought.

1/ Written comment of the Putnam Management Company, Inc., at 4.

2/ Tr. 209.

"Further, they are only sold if the salesman is adequately compensated for his effort. Based on discussions with dealers over the last several years, we are convinced that the reduction in overall compensation from selling our funds' shares has contributed to the decline in sales. If 22(d) is repealed we think there will be enough fund share selling at reduced commission rates by large dealers who sell mutual fund shares only as a minimal part of their business to make it difficult or impossible for dealers, to whom mutual fund sales would be significant, to compete." 1/

Other fund managers, while also not favoring repeal of Section 22(d), did see merit in certain modifications of the present distribution system. For example, F. Eberstadt & Co., in its written comment, suggested, inter alia, liberalization of rules governing advertising and group purchasing.2/ During the hearings, the company's president, Robert C. Porter, expressed the hope that increased advertising would, besides increasing sales, result in reduced sales loads:

"I think we would hope that if we did this kind of advertising that the salesmen wouldn't have to work quite so hard and hopefully the spreads might come down a little bit. I mean that would be the optimum idea.

"I mean there is no question in my mind that having to absorb an 8-1/2 percent sales charge and having to perform to make that up is a hindrance. I mean that is a hurdle to get over. And therefore you have to balance that hurdle against whether you can sell the fund some other way. And I think this type of advertising that [another of Eberstadt's witnesses] has suggested would go -- would certainly open up a lot of leads for us and a lot of interest that we don't have at the moment." 3/

The Eberstadt presentation suggested that, assuming "a positive relationship between advertising and merchandising and lower distribution costs," Section 22(d) could ultimately be abolished, provided that the fund sponsor is afforded certain protections. 4/. Specifically, the sponsor should set the amount of its initial service fee, and impose a fee on transfers and redemptions. 5/ The purpose of the transfer fee, according to another of Eberstadt's witnesses, would be to "eliminate the bootleg market in mutual fund shares" by in effect penalizing "a secondary market maker by adding on a layer of cost of 1-1/2 percent...." 6/

1/ Tr. 306-307.

2/ Written comment of F. Eberstadt & Co., at 6.

3/ Tr. 753.

4/ Written comment of F. Eberstadt & Co., appendix, at 2.

5/ Ibid.

6/ Testimony of Robert Perez, Tr. 829.

The Union Service Corporation, representing a group of four mutual funds, while opposing repeal or modification of Section 22(d), nevertheless saw "other routes to be followed if it is determined that we have come to the end of Section 22(d)." 1/ Specifically, the company suggested that -- if Section 22(d) must be altered -- contract dealers be permitted to set their own retail prices up to a maximum of 8.5%; however, they would be required to set the same price scale and salesmen's compensation for all fund shares they sold, and a secondary market would not be permitted. 2/

At the hearings, however, the company's president, H. Bridgman Griswold, emphasized that Union Service's basic position was that Section 22(d) was a valuable provision which should not be repealed:

> " * * * I think that there is good competition in the industry, and I think that prices are coming down in the industry through this competition, and I think that 22(d) is necessary to protect the pricing in the industry so that we can control our distribution, so that we can have our funds sold by dealers who sell them properly.
>
> "One of the great benefits of being able to work with the dealers that we choose via the 22(d) route is that we are able to have our product sold correctly, we are able to have our product represented at a time when a customer has a question as to whether he should continue in the funds, and one of the results of that has been that our redemption rate is considerably lower than the industry. So that our selling techniques have benefited the organization and our shareholders, we believe." 3/

Nor did Mr. Griswold think that gradual repeal would be a suitable alternative:

> "I found great problem with [another witness's suggestion of] partial repeal of 22(d) because I think one of our great difficulties today is that the question of 22(d) is overhanging the industry, and a partial repeal with the end objective of total repeal would overhang the industry like a sword of Damocles. Nobody would want to buy today because prices may be reduced later." 4/

1/ Written comment of Union Service Corporation, at 11.

2/ Ibid.

3/ Tr. 2205-06.

4/ Tr. 2204.

Investors Diversified Services, Inc., strongly opposed repeal of Section 22(d), arguing that such repeal would require the end of retail price maintenance and limit the availability to the public of mutual funds and related services.

> "In our view 'maximization of the opportunities for open and fair competition' requires preservation of the right of every participant in the competitive arena to determine for itself how it competes. It means the right to determine how it sells, to whom it sells, and at what price it sells in competition with others who should have the same right of self-determination. IDS has chosen to compete in the sale of mutual funds through a distribution system which emphasizes the furnishing of personalized financial services .... We believe that for ourselves this is the right way to compete. If others choose to compete in a different way, that is their business. Because Section 22(d) protects our freedom to compete in the way we believe is right, and allows us to maintain control over our distribution organization in a manner commensurate with our responsibilities under the securities laws, we support its retention." 1/

IDS added that expanded grouping would be administratively unenforceable, unless it were limited to employee/employer relationships; and that even if grouping were so limited, its discriminatory consequences should be considered. 2/ At the hearings, Robert Loeffler, Senior Vice President of IDS, elaborated upon his misgivings with regard to grouping:

> "I think what disturbs me with the grouping proposal is that I am fearful that in the development of it we may destroy the distribution system which exists for the service of the non-group market, which is the principal market today that is being served. Let me put it this way: Certainly if you go beyond a very restricted definition of a group and we get into the airline charter type things, I don't think you can maintain the distribution system we have today, because then everybody is a member of both systems and is a target for both systems.

1/ Written comment of Investors Diversified Services, Inc., at 79.

2/ *Id*. at 82-83.

"I discovered the other day, for example, that I am a member of the Swedish-American Club, and I found that was because my wife sent $2 to be a member of the Swedish-American Club once when she was looking at airline charters to some place or another. Every person can be. And I don't know how you go to a customer and try and service him with his financial services under a distribution system such as exists today to give him a full service and full information and all that data and then end up saying, oh, but by the way, for $2 you can join something and get the same result now without paying me anything."

STAFF QUESTION: "Isn't the difference, though, that he probably will get different services if he buys the fund shares through the Swedish-American Club or its equivalent?"

MR. LOEFFLER: "I don't think the services will continue to exist on a dual basis. In other words, this is what I am saying: That you will destroy the distribution system, the individualized distribution system if you want to call it that, as it exists today. To go back thirty years, to my course in elementary economics, the /Gresham's/ law that says bad money drives out the good or something like that." 1/

IDS did favor liberalization of the restrictions on advertising, although it cautioned that advertising should not be regarded as a substitute for the personalized services provided by salesmen. 2/

At another point in the hearings, Mr. Loeffler, though arguing against repeal of Section 22(d), suggested that retail price maintenance might not always be so important to IDS:

1/ Tr. 2249-50.

2/ Written comment of IDS, at 84.

"Now, as time goes on and the public becomes more and more aware of mutual funds -- and they are -- and mutual funds do not have to be explained to the extent that they are today, and they don't have to be sold in the sense that they are sold today, to that extent, then in actuality the sales representative isn't going to be spending that much time on them, he won't have to, which means that his time, which is what he has to sell to earn a living, really, will produce more volume of sales for the same amount of time, which means that from an income standpoint you can drop the commission necessary for him per dollar of sales to still sustain the distribution system.

"There will come a time when that would probably reach a point where it would be competitive with what the spread might be on just as a shelf product, which it would be in the secondary market, at which point you could repeal 22(d) and it probably wouldn't make any difference because your levels would be the same.

* * * *

"Now I don't know when that time is going to come. I suspect that I probably may feel it is longer -- further distant than [one of the other witnesses] does. But I think ultimately that is where it comes, because I think you have competition in the industry today with 22(d). And self-interest is going to take us there. I look at it from the standpoint of the self-interest of IDS, and we are trying desperately to get the sales load down to make more efficient our own distribution system. And I think we will. But I don't know how long this is going to take, but ultimately I would see that coming out at that point and then I think 22(d) becomes immaterial." 1/

3. No-Load Mutual Fund Association

Since the no-load funds' interest in sales charges is indirect at most, the No-Load Mutual Fund Association had no definitive position on the question of whether Section 22(d) should be repealed. 2/ Its Executive Vice President, Donald Samuel, stated at the hearings that the no-load funds' "principal concern" was "with the still archaic and inhibiting advertising rules for all mutual funds as contained in the SEC Rule 134." 3/

1/ Tr. 2201-02.

2/ Charles W. Shaeffer, President of the No-Load Mutual Fund Association, while taking a "neutral" position on amendment or repeal of Section 22(d), did say at the mutual fund distribution hearings:

> "I would like to underline one comment in our position paper and that is the necessity to 'spread the word about mutual funds.' Not everyone is inclined to 'do it yourself.' There has been in the past and will be in the future many people who need the assistance of a third party. If we go to an environment totally without commission salesmen, I think the mutual fund industry will not reach the broad public which needs to be served." Tr. 499.

3/ Tr. 401.

With respect to advertising, Mr. Samuel left no doubt as to the no-load industry's position:

> "We are simply asking that advertising for mutual funds be liberalized sufficiently, and this in our opinion would require substantial liberalization, the prospective investors would be induced or, if you will, seduced into sending for a prospectus, not the check, -- the prospectus.
>
> "Or in the case of a load fund, would be more likely to listen to a salesman.
>
> "We are still laboring with a 40-year old tombstone type of advertisement, just as though our securities were new and unseasoned." 1/

Mr. Samuel then pointed out that aggressive advertising is used in marketing other financial products such as savings deposits and U.S. savings bonds. 2/

4. Broker-Dealers.

a. NASD.

The NASD opposes repeal of Section 22(d). It argued that, on the one hand, retail price maintenance has not precluded price and product competition among funds, and has not resulted in excessive earnings by underwriters, broker-dealers, or salesmen. 3/ On the other hand, whatever limited benefits might derive from a repeal of Section 22(d) would be more than offset by the adverse effects of a secondary market in fund shares, in the view of the NASD. 4/ The NASD says that the existence of such a secondary market, with resulting cut-price competition, would induce underwriters and contract dealers to reduce their sales efforts and services to investors, and would drive many smaller retail firms from the mutual fund business, thereby accelerating the trend toward concentration. 5/ The NASD adds that the adverse impact on sales efforts would likely be far greater than the stimulation of demand resulting from lower sales charges, and therefore an increase in net redemptions would be probable. 6/

1/ Tr. 402.

2/ Tr. 403-404.

3/ Letter summarizing statement of NASD, at 3.

4/ *Ibid*.

5/ *Id*. at 3-4.

6/ *Id*. at 4.

However, the NASD did say that it supported "the evolution toward enhanced competiton":

> "We do not contend that the present distribution system is of optimum efficiency. We believe that improvements are possible in the areas of group sales and advertising. We favor a redefinition of the concept of a 'group' purchase, provided that any relaxation of current sales is limited and does not degenerate into massive discrimination among buyers and a means of undercutting the incentive necessary for the individual sales effort. . . .
>
> "We support the evolution toward enhanced competition and improvements in the efficiency of the distribution system. We believe the modification of regulations that have stifled competition, particularly in the areas of administration and advertising, will aid that evolution. If the removal of these stifling forces result in substantial economies, we would expect the competitive forces in the industry to pass on these savings to investors in the form of lower sales charges. Pending tangible results, we oppose modification of 22(d)." 1/

With respect to the Statement of Policy, the NASD agreed:

> "that the existing provisions of the Statement of Policy should be reviewed in light of current conditions and, while we believe that most of the provisions of the Statement of Policy have served, and are now serving, to clarify acceptable approaches to the preparation and distribution of sales literature, there are certain provisions which should be reevaluated." 2/

1/ Ibid.

2/ Statement of NASD at 59.

b. Securities Industry Association.

The SIA warned that repeal of Section 22(d) would not provide any real benefits for investors, but rather would discourage fund sales. The nature of fund purchasers, and of the product itself, makes funds particularly expensive and difficult to sell. 1/ Firms located in small communities, serving small investors, would be hardest hit by a repeal of Section 22(d), according to the SIA. 2/ Furthermore, the SIA was of the view that repeal of Section 22(d) could harm investors:

> "If the effect of repeal is to reduce the sales charge, and therefore the salesman's compensation, we may find salesmen unwilling to devote their professional efforts to selling fund shares on the basis of suitability, proper fund choice, and an explanation of all the features of each fund. The salesman may merely write the order ticket, without giving the investor full, in-depth investment counseling." 3/

On the other hand, the SIA did see merit in some of the suggestions set forth in Investment Company Act Release No. 7475, such as liberalized advertising, revision of the Statement of Policy, and broadening the definition of "group" for purposes of discounts. 4/

c. Large Broker-Dealers.

i. National Mutual Fund Managers Association.

The members of this association are mutual fund sales managers of New York Stock Exchange member firms. The Association's President, Bradley Baker, testified that, although mutual fund sales commissions represent only about 3% of member firms' total income, such firms regard the sale of mutual funds as an important service for their customers. 5/ Accordingly, the Association opposed repeal of Section 22(d), arguing that negotiated rates would lead to less compensation for salesmen, and this in turn would discourage salesmen from making the extensive effort needed to sell fund shares. 6/

1/ Written comment of Securities Industry Association, at 3.

2/ *Id.* at 4.

3/ *Id.* at 5.

4/ *Id.* at 7-8.

5/ Tr. 1022-23.

6/ Testimony of Mr. Baker, Tr. 1023-24.

ii. Merrill Lynch, Pierce, Fenner & Smith, Inc.

Unlike most of the industry participants, this large broker-dealer was not sure that Section 22(d) should be retained. In its written comment, the firm stated that it is:

> "not certain that the fixed price system as it has developed, has always functioned equitably in the past nor that a negotiated price system would lead to the utter destruction of the industry and to complete chaos in our various markets." 1/

Merrill Lynch offered three suggestions for consideration in lieu of the present distribution system:

> "a) The first alternative would allow a fund to elect in its prospectus to be sold at retail at net asset value plus negotiated prices only.
>
> "b) The second alternative would allow a fund to elect to be sold at negotiated prices within a maximum and minimum structure established by the fund, the difference between such maximum and minimum never exceeding five percentage points.
>
> "c) The third alternative would permit a fund which meets the standards proposed by the NASD in their November 6, 1972 statement for charging the maximum rates, to elect to be sold at a fixed price schedule, again imposing a five percentage point limitation on the spread between the maximum and minimum loads." 2/

At the hearings, Joel Matcovsky, an attorney for Merrill Lynch, indicated that the company thought its proposal would introduce an element of price competition in the sale of fund shares while at the same time allow funds to maintain some control over their prices. 3/ Mr. Matcovsky also suggested that, insofar as a fund elects to be protected from retail price competition, it should be willing to accept regulation as a substitute:

1/ Written comment of Merrill Lynch, Pierce, Fenner & Smith, Inc., at 3.

2/ Ibid.

3/ Tr. 254.

"Basically, I think the philosophy underlying this proposal is that in our society competitive prices should be the norm. And as someone moves away from this for every step away they take from this norm something should be given back in return. So, for example, if they elect negotiated rates, well that is that.

"If they elect negotiated rates within a floor and ceiling which they would establish, then perhaps the floor and ceiling, the difference between them should be regulated and we suggest five percentage points.

"We, [threw] that out for discussion and consideration. But if they want to go an additional step and not have only a floor and ceiling but have a fixed rate structure within the floor and ceiling, then perhaps the maximum actual figures should be regulated.

"We suggested in our proposal that only funds which met the requirements [f]or the imposition of the maximum charge under the NASD proposals would be permitted to elect the fixed schedule alternative C." 1/

However, at a later point, Robert Cleary, Vice President of Merrill Lynch, made clear that the company sympathized with the concerns expressed by other industry witnesses with regard to the consequences of partial or total retail price competition:

STAFF QUESTION: "What would you think of a proposal that would permit competitive pricing for the large orders?"

MR. CLEARY: "Well, I think we have got a can of worms . . . . This, I think, is why . . . we still have not made a determination. If we go out and sell for the sake of discussion a ten million dollar order which will take six to eight months and more to put together, to a pension fund, whose trustees have a fiduciary responsibility, and. . . Merrill, has spent the time and talent to convince these people and show them that this is the proper product for their retiring employees, and if they walk out of their meeting in the Cleveland Plain Dealer, a little squib, say Bob Cleary will sell you any mutual funds for a half of one percent. As a fudiciary trustee Merrill Lynch will have to say, 'Look, we are going to have to sell it at two, you have to buy it from me at 1-1/2 percent.

1/ Tr. 254-55.

". . . That is going to happen to one of my guys one time, that is all. Then he can't afford to take the time and spend the effort to go after something and then be cut out because of the price." 1/

Later, Mr. Cleary was asked how total repeal of Section 22(d) might affect Merrill Lynch. He said:

> "I have to agree with the previous speakers, and emphatically agree funds are sold, they are not bought. Of our 29 products, I would like to add one of the very few things that all Merrill Lynch people agree with, and I assure you there are precious few, they all agree a mutual fund is the toughest product we have to sell.
>
> "So, if we get into negotiated rates, and if there is some manner or means whereby these can be undercut, be there a small dealer in Cleveland that doesn't need any capital to do mutual funds, it could certainly slow down our efforts particularly in the bigger tickets which take the most amount of time, and talent.
>
> "I am not saying it would, but I am saying it could." 2/

d. Small Broker-Dealers.

Of all the industry representatives who opposed repeal of Section 22(d), perhaps none expressed such opposition more strongly than the small broker-dealers. Raymond Cocchi, President of the Independent Broker-Dealers Trade Association,3/ stated his organization's view as follows:

> "We oppose complete or partial repeal of Section 22(d), as the adverse impact would fall most heavily on independent broker-dealer firms, particularly the smaller ones. Further diminution of mutual fund selling incentives will only speed up the trend of mutual fund sellers to find other financial products, some regulated by the SEC and NASD and some not." 4/

Mr. Cocchi also asked the Commission to:

> "bear in mind that the Congress has made it clear that reasonable sales loads to investors is only one of the policy goals the SEC must take into account. Congress saw to it in Section 22(b) of the Investment Company Act that mutual fund sales charges must also allow for reasonable compensation for sales personnel, broker-dealers and underwriters. 5/

1/ Tr. 258-59.

2/ Tr. 260.

3/ Mr. Cocchi has since been appointed Commissioner of Securities of the Commonwealth of Massachusetts.

4/ Tr. 836.

5/ Tr. 837.

* * * * *

"I find it particularly disturbing that Chairman Casey states in the letter [of transmittal accompanying the staff report] that with respect to these [independent] dealers: 'It should be noted that the mutual fund industry is far more important to these firms than they are to it.'

"With all due respect to Chairman Casey, I must say that this statement seems to be inconsistent with a broad national policy of our federal government.

* * * * *

"It would seem to me that the SEC cannot, within the broad policy goal of Congress to encourage small business, simply write off the small business segment of the securities industry." 1/

Mr. Cocchi concluded that:

"Implementation of the NASD sales charge study, coupled with further relaxation of advertising restrictions and an evenhanded application of the 'anti-reciprocal' rule, given time, could help a crippled industry get back on its feet." 2/

The notion that small dealers subject to relatively high operating costs might need higher sales loads to survive was explored in an exchange between the staff and Carl L. Shipley, counsel for the Independent Broker-Dealers Trade Association. When asked whether Section 22(b) of the Act might enable the Commission to allow such small dealers to charge relatively higher sales loads,3/ he responded that it would, but that such a dual pricing system would be unworkable.4/ However, upon further analysis he took the position that such a dual (or multiple) price system might be both feasible and justifiable, although it would be necessary to devise some means of protecting small dealers from the effects of large dealers charging lower sales loads.5/

1/ Tr. 839-40.

2/ Tr. 840.

3/ Tr. 880. The concluding sentence of Section 22(b)(1) reads: "The Commission shall on application or otherwise, if it appears that smaller companies are subject to relatively higher operating costs, make due allowance therefor by granting any such company or class of companies appropriate qualified exemptions from the provisions of this section."

4/ Tr. 881, 882.

5/ Tr. 883-87.

In any event, the basic thrust of the small broker-dealers' argument was that retail price competition would effectively put them out of business, and that this would be undesirable not only for them but also for investors who need their services. Orville H. Lauver, an independent broker-dealer in York, Pennsylvania, stated the matter in personal terms:

> "The several thousand clients I have introduced to funds would not have been introduced to funds had I not gotten into the market, they are these low income elements Merrill Lynch is not touching. Yet, if they are able to now with the greater advertising plans and things that people are doing, having introduced a lot of these people to funds, I think I will lose those clients because they are now [knowledgeable] and sophisticated enough to go elsewhere. I have put in the legwork, and hopefully -- again, it sounds greedy on my part -- to continue to benefit. I perform the service and I continue to perform it every day in the form of service. I am sure you have been besieged with discount stores and if you can find something at a discount you naturally try to pick it up. That still puts me out of business that I am not able to at least introduce someone new who has never heard the story and will never hear the story, regardless of whether they can get it for nothing. But that is not like most people who buy a mutual fund. We try to take our time to inform them. I lose a lot of sales to no-loads, where people say you told me all about it, I don't want to pay the 8-1/2, so I will buy . . . something else. I understand that. I lose sales in that fashion. I still feel what I am doing is providing a service to my clientele and I feel I have performed help to people . . . .
>
> " . . . I am trying to be helpful to my fellow man, and I feel my days are quite numbered if this goes into effect." 1/

B. Variable Annuities -- American Life Insurance Association.

The ALIA, whose interest in this proceeding was limited to Section 22(d)'s effect upon variable annuities funded in registered separate accounts, 2/ said that the section should not be applied to the sale of this product. 3/ They argued that Section 22(d) was aimed at preventing essentially two results: disruption of the distribution system, and discrimination in sales loads. 4/ The ALIA contended that disruption of the distribution system could not occur if Section 22(d) did not apply to variable

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1/ Tr. 896-98.

2/ Although some life insurance companies have mutual fund affiliates, the ALIA expressly disclaimed any intention to present such mutual funds' positions. Written comment of ALIA, at 1.

3/ Written comment of ALIA, at 2.

4/ Ibid.

annuities because, in part, variable annuities are not, and by their nature cannot be, traded in a secondary market. 1/ Nor is the section necessary to prevent discrimination in variable annuity sales, according to the ALIA. They pointed out that the Commission has already granted numerous exemptions permitting variable annuity sales charges to vary where the variations are not unfair. 2/ Accordingly, the ALIA recommended that variable annuities be exempted from Section 22(d) subject to appropriate safeguards against unfair discrimination. 3/

The ALIA also suggested:

> "a new approach to investment company advertising by simply adopting rules which would permit the use of any advertising which was not fraudulent and, in this connection, we recommend the formulation of a new Statement of Policy." 4/

With respect to the Statement of Policy, the ALIA urged that issuers of variable annuities be permitted to present illustrations of hypothetical investment results. 5/

C. Participants Not Representing the Industry.

The participants who were not directly associated with the mutual fund industry or fund distribution generally favored an elimination of retail price maintenance in the sale of fund shares, although most of them suggested that this be accomplished eventually rather than immediately.

1. Department of Justice.

The Department of Justice favored a complete end to retail price maintenance:

> "Resale price maintenance of the sales load on mutual fund shares increases the cost of buying fund shares without any compensating benefit to the investor and should be ended." 6/

1/ *Id*. at 5-6.

2/ *Id*. at 10-13.

3/ *Id*. at 14.

4/ *Id*. at 16.

5/ Testimony of Robert Routier, Tr. 1521. The Commission has separately taken action to permit such illustrations. Investment Co. Act Rel. No. 8438, July 1974.

6/ Written comment of Department of Justice at 2.

The Department was of the further view that retail price maintenance should be abolished immediately, and that a gradual phasing out was not necessary. 1/

In addition, the Justice Department took the position:

> "that the Commission has the power under §6(c) of the Investment Company Act to eliminate the adverse effects of the resale price maintenance provisions of §22(d) and need not wait for repeal."2/

At one point the Department "urge[d] the Commission to use this power," 3/ but at the hearings its spokesman characterized such administrative action as "a less satisfactory alternative to outright repeal of Section 22(d)." 4/

The Justice Department found no justification for the anticompetitive effects of Section 22(d). On the one hand, it argued that retail price maintenance results in unnecessarily high prices, 5/ directs competition into the undesirable arena of short-term performance, 6/ and exacerbates a conflict of interest on the part of broker-dealers in advising investors. 7/

On the other hand, repeal of Section 22(d) would not disrupt the distribution system, according to the Justice Department, because contract dealers, like secondary dealers would not be required -- or even permitted under the anti-trust laws -- to sell shares at fixed prices and therefore would have no reason to cancel their contracts as they did prior to 1940. 8/ Moreover, the Department argued that lower sales loads would increase, rather than decrease, sales. 9/ With respect to the possibility of unfair discrimination, the Department said that competitive forces would prevent a dealer from charging higher prices to particular investors except where such higher prices are required by cost differences. 10/ The Justice Department conceded that retail price competition might force some salesmen out of the business, but it contended that marginal salesmen account for only a small portion of industry revenues and that the

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1/ Id. at 23.

2/ Id. at 2-3.

3/ Id. at 3.

4/ Statement of Barry Grossman, Tr. 2020.

5/ Written comment of Department of Justice, at 5-7, 8-9.

6/ Id. at 8.

7/ Id. at 9-10.

8/ Id. at 15-17.

9/ Id. at 17-19.

10/ Id. at 20-21.

> "investing public should not be saddled with permanently high sales loads in order to preserve this small proportion of industry revenues in the hands of inefficient salesmen who could not survive the rigors of competition." 1/

Since the Justice Department favored full retail price competition, it favored expanded grouping only as a "decidedly inferior" alternative. 2/ It did favor more informative advertising and more easily understandable prospectuses. 3/

2. Henry C. Wallich.

Mr. Wallich, Knox Professor of Economics at Yale University, 4/ submitted a statement in which he indicated that his "overall conclusion" with respect to mutual fund sales charges was in favor of a free market and flexible price. 5/ However, Mr. Wallich did not recommend an immediate implementation of fully-negotiated sales loads, since in his view such an:

> "immediate move would work hardship on at least some parts of the industry. It might also have a very undesirable effect in increasing net redemptions of funds . . . ." 6/

Instead, Mr. Wallich advocated a:

> "transition to negotiated sales loads in a period of stages. This could be done by gradually reducing the maximum size of transactions for which a fund or its principal underwriter could fix the sales load. This would resemble the procedure employed by the New York Stock Exchange with respect to negotiated commissions. Alternatively, it might be possible to reduce, year by year, the minimum sales load that the fund or its principal underwriter could stipulate. This would not interfere with the negotiation of higher sales loads if competition permits. At some point, presumably the competitive rate would tend to establish itself above the minimum, if funds are to be sold by salesmen at all." 7/

1/ Id. at 23.

2/ Id. at 44.

3/ Id. at 43-44.

4/ Mr. Wallich has since been appointed a Governor of the Federal Reserve Board.

5/ Written comment of Henry C. Wallich, at 1.

6/ Id. at 5.

7/ Ibid.

Mr. Wallich went on to suggest that the transition to retail price competition could be eased by simplification of prospectuses, group sales, reduction of paper work and volumediscounts. 1/ Mr. Wallich also favored greater freedom to advertise, although he cautioned that advertising of performance would be undesirable. 2/ He argued:

> "that good performance, when it occurs, is as likely to be the result of random events as of skillful management. Funds selling performance are selling something that they cannot promise to deliver . . . . Performance advertising, moreover, tends to produce switches from one fund to another, which in the case of funds charging substantial sales loads surely is harmful for the investor on average. An institutional form of advertising, stressing the benefits of mutual fund investment as such, would be more appropriate." 3/

3. Donald Farrar.

Dr. Farrar is an economist who directed the Commission's Institutional Investor Study in 1969 and 1970, and at the time he testified was a senior research associate at the National Bureau of Research. 4/ He stated his position as follows:

> "I do not at this point favor the repeal of [Section] 22(d). I do, however, believe that [Section] 22(d) should over time be eroded and at some time perhaps in the not too far distant future it could actually be repealed." 5/

Dr. Farrar expressed the view that mutual funds are a sufficiently good product to survive in a competitive environment, 6/ but that:

> "[t]here are some very serious problems in the distribution system at the present time which are an accumulation of an evolutionary process over time and which must be dealt with." 7/

Dr. Farrar suggested that the problems could be dealt with "by attempting to change one's general direction . . . away from price fixing. . . ," 8/ in order to reach segments of the market which cannot be developed under the present system. He indicated that the growth of such a market might be "partially at the expense of the more traditional market that does rely upon a one-to-one contact between the salesman and the customer." 9/

1/ Ibid.

2/ Ibid.

3/ Ibid.

4/ Dr. Farrar is currently a professor of economics at the University of of California at Los Angeles.

5/ Tr. 2193.

6/ Tr. 2195-96.

7/ Tr. 2196.

8/ Ibid.

9/ Ibid.

In advocating the "erosion" of section 22(d), Dr. Farrar suggested the following initial steps: increased advertising, including advertising of performance; 1/ expanded group sales; 2/ incentives for broker-dealers to recommend no-load funds; 3/ and price competition on purchases larger than a prescribed amount. 4/

The contention that eventual retail price competition would lead to a concentration of fund sales among large broker-dealers was rejected by Dr. Farrar:

> "I don't believe that Merrill Lynch has any particular competitive advantage over any other broker-dealer in the sale of fund shares. It has and would have the same types of suitability requirements that other broker-dealers would have. Other broker-dealers like Merrill Lynch also will have their own sales network. They also will have their own customers.
>
> "I see no evidence in the regular brokerage area that Merrill Lynch is going to emerge as the sole participant in the brokerage industry. I would be equally surprised if Merrill Lynch would emerge as the sole distributor of mutual fund shares." 5/

4. John L. Asling.

The appearance of Mr. Asling provided the only opportunity during the hearings to obtain an investor's view of Section 22(d). Mr. Asling made his first purchase of fund shares -- in the amount of $1,000 -- in 1955, 6/ when by his admission he "was an uninformed investor and . . . knew absolutely nothing about it . . . . "7/ To the best of his uncertain recollection, his interest in contacting a broker was inspired by a newspaper advertisement; 8/ in any event, his decision to buy the shares came after he had received extensive selling service from the broker:

1/ Tr. 2229-30.

2/ Tr. 2230.

3/ Ibid.

4/ Tr. 2230-40.

5/ Tr. 2224.

6/ Tr. 694.

7/ Tr. 696.

8/ Tr. 694.

"I would say that we probably kicked this thing around for approximately two hours, because I had him to explain the situation of the fund, the operation. Of course, I didn't read the prospectus at that particular time so it was more or less I got my information from him verbally." 1/

Mr. Asling did not appear to resent paying a sales load on this initial purchase. However, he did question the fairness of being required to pay a sales load when he later decided to purchase additional shares of the same fund, and neither needed nor received further selling service from the broker:

STAFF QUESTION: "Surely you expected Mr. Thomas [the broker] to receive some compensation for the time he spent with you."

MR. ASLING: "Yes, I did. Like I say, he probably spent a couple hours in my original purchase. From then on, in all the purchases of shares of Washington Mutual Investors Fund [the same fund which had been purchased initially], he didn't solicit me. All he had to do was pick up the phone and I said I am placing an order with you to buy X number shares of Washington Mutual Investors Fund. And that is a pretty high reward to sit back there and pick up the phone and draw 4, 4-1/2 percent sales commission."

STAFF QUESTION: "So your quarrel is not with the sales commission he received on the first sale, but on the repeat sales?"

MR. ASLING: "I would say yes. I would say basically this: That in the original sales effort no doubt that the broker did spend considerable time, and of course nobody works for nothing. And I think that probably he would be rightly rewarded in that respect. However, on all future purchases I had made up my own mind and I decided which fund I was going to buy . . . . [I]t doesn't take but approximately a minute, I would say, to place this order of his time, and I think it is very high compensation for the amount of time spent." 2/

Subsequently, Mr. Asling learned about no-load funds, and eventually began investing in them to the exclusion of load funds. 3/ However, even after his movement to no-load funds, Mr. Asling continued his concern with the retail price maintenance system. At the time of the

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1/ Tr. 697.

2/ Tr. 700-01.

3/ Tr. 702-05.

hearings, Mr. Asling's largest fund holding was still Washington Mutual, 1/ and:

> "About a year ago I began to wonder why I should have to redeem my Washington Mutual shares at 9.3% less than other people were buying them for and who could just as easily buy them from me and profit everyone." 2/

Whereupon, Mr. Asling commenced an attempt to sell his shares on a brokered basis. As of the date of his testimony "certain things /had/ not been worked out yet" and he still owned his shares. 4/

1/ Tr. 684.

2/ Ibid.

3/ Tr. 684-93.

4/ Tr. 692. Uniform sales agreements between principal underwriters and broker-dealers typically contain provisions which prevent broker-dealers from acting as agent for the purchase and sale of shares in a secondary market. A U.S. District Court has dismissed antitrust complaints against such provisions. U.S. v. NASD CCH Fed. Sec. L. Rep. ¶ 94,319 /1973-74 Transfer Binder/ 1973. The Department of Justice is appealing the decision to the U.S. Supreme Court.

V. THE RECOMMENDATION OF THE DIVISION: GRADUAL CHANGES IN THE DISTRIBUTION PROCESS THROUGH ADMINISTRATIVE ACTION.

We start with the premise that mutual funds are a worthwhile investment medium and that the basic fund concept should be fostered. No type of security is subject to more detailed regulation than mutual funds. Implicit in the decision of Congress to establish a thoroughgoing statutory scheme to govern mutual funds is a determination that mutual funds are a product which, with appropriate safeguards, should be made available to the public. While the Division would not suggest that any particular investor should buy mutual funds, neither would it recommend action which would disrupt the fund distribution system. Thus the Division's proposals are designed to deal with the inequities and inefficiencies in the current mutual fund distribution system in a manner which will accommodate, to the extent possible, the interests of both investors and the industry.

A. The Choices Available to the Commission.

Broadly stated, the courses of action available to the Commission fall into three categories: (1) accept continuation of the retail price maintenance system with greater emphasis on price regulation under Section 22(b); (2) urge immediate abolition of the present system; and (3) adopt a gradual program designed to move toward a more competitive environment.

1. Continuation of the Present System of Retail Price Maintenance With Greater Emphasis on Price Regulation Under Section 22(b).

This would involve no major modifications of the law presently governing fund distribution except implementation of a meaningful maximum sales load rule; the mutual fund distribution system's basic reliance upon fixed sales loads to encourage intensive personal selling efforts would remain unchanged. This approach would have two principal drawbacks. It would perpetuate the inefficiencies and inequities of the current distribution system, and it would be based upon a presumption that the NASD recommended maximum sales charge rule, or a revised version of its recommendations, would be an appropriate substitute for increased price competition, a presumption contrary to our own analysis and judgment of the situation.

We believe that increased competition would improve efficiency and is the best way to establish meaningful sales charges as well. As the Senate Securities Subcommittee put it, in the context of stock exchange commission rates:

> "Vigorous competition is a vital element in creating an efficient industry. In a freely competitive marketplace, efficient firms prosper and grow and inefficient firms wither and die. By rewarding the capable competitor and

eliminating the inept, this winnowing benefits the public in a number of important ways. The efficient firms have a salutary effect on all prices in the industry preventing, to some extent, the inefficient from raising prices to a level reflecting their inefficiency." 1/

The Commission itself has framed the question of competition in the fund industry this way:

> "The system of retail price maintenance under which mutual funds are distributed tends to raise rather than lower prices. Under it, fund distributors compete for the favor of dealers and salesmen through a system of sales incentives which creates a constant pressure to raise sales loads or reduce the principal underwriter's margin.
>
> "The question is whether there is any longer sufficient public interest in the continuation of this system as an exception to the general rule of free competition which prevails in most other segments of our economic life." 2/

At the mutual fund hearings the Department of Justice suggested that restrictions on price competition tend to encourage "less desirable forms" of competition: 3/

> "The absence of vigorous price competition in sales loads has directed rivalry, particularly in the past few years, to short-term fund performance, ignoring possible detriment to fund shareholders from such action." 4/

1/ U.S. Senate Committee on Banking, Housing and Urban Affairs, Report of the Subcommittee on Securities, Securities Industry Study, 93rd Cong., 1st Sess. 44 ("Senate Securities Study") (1973). citing testimony of Dr. Farrar, 6 Study of the Securities Industry, Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 92nd Cong., 2d Sess., at 2947.

2/ Investment Company Act Release No. 7475, at 4.

3/ Written comment of Department of Justice, at 8.

4/ Ibid. In this regard, the Senate Securities Study also noted (at p. 46):

> "Where prices are fixed, firms cannot compete by offering lower prices to their customers. Therefore, firms compete by offering their customers additional services. These additional services often are expensive and add to fixed costs. In many cases, the value of these services to customers is not proportionate to the cost of providing them. Moreover, the steady growth of fixed costs resulting from this service competition creates continuous upward pressure on the commission rate schedule."

2. Immediate Abolition of the Retail Price Maintenance System.

The Commission could recommend to Congress that it take action immediately to eliminate Section 22(d) completely in order to permit the establishment of price competition in the sale of mutual fund shares; or, it could attempt to accomplish that goal administratively by developing rules now which would, to the extent possible, exempt underwriters from the requirements of the section . Either approach would be in accord with the recommendation of the Department of Justice. Without Section 22(d) retailers would be permitted to sell shares of any fund at whatever mark-up they chose, although it might also be necessary specifically to prohibit unjust discrimination at the same time. 1/ In addition, since the NASD and the Commission have the power to impose ceilings on sales loads under Section 22(b)(1), which authorizes rules prohibiting "excessive" sales charges, to prevent such a ceiling from also becoming a fixed minimum rate it might be necessary to ask the Congress to modify that section if the Commission chose full retail price competition. 2/ On the other hand, it would seem, in theory at least, that there would be no need to adopt any rules under Section 22(b) since, if the competitive market pricing mechanism is able to function, it should prevent both excessive charges and price differentials which are not economically rational.

1/ For an example of such an approach, see our recommendations with respect to exempting variable annuities from Section 22(d) at pp. 102-103, infra.

2/ A literal reading of Section 22(b)(1) might suggest that it would permit the NASD or the Commission to issue rules prescribing fixed, or at least minimum, sales loads notwithstanding the absence of Section 22(d). The preferred view, however, is that Section 22(b) is intended only to authorize rules prescribing maximum sales loads. See letter from Assistant Attorney General McKevitt to Chairman Staggers of the House Committee on Interstate and Foreign Commerce, undated, concerning H.R. 6821 (the Oil and Gas Investment Act of 1973); and letter from the Commission to Chairman Staggers, November 2,1973.

We do not believe it would be wise to move precipitously to a fully competitive environment. For more than three decades, the marketing strategy of the mutual fund industry has been to rely almost exclusively upon a sales "push" rather than the development of a demand "pull;" or, as the industry puts it, fund shares have been "sold, not bought." The fact that the industry has not yet succeeded in producing a demand "pull" for fund shares is dramatically illustrated by the ICI's finding in 1970 that more than two-thirds of American adults know nothing about mutual funds. 1/ In this regard, the present regulatory system, while failing to foster an adequate sales "push," has inhibited the development of a demand "pull" by prohibiting the fund industry from using the marketing devices relied upon by most other businesses: lower prices, effective advertising, and mass-merchandising techniques such as group discounts. Dr. Farrar suggested that this puts the industry in an awkward position:

> "It appears to me that the mutual funds are essentially . . . caught between the stools, if you will. They are not effective competitors who are becoming increasingly less effective competitors for the salesman's favor, and yet they are not sufficiently competitive for the investor's favor to develop a market demand rather than a sales push.
>
> "If the industry is to maintain or develop a viable distribution network under present circumstances, where the losses of revenue to them are substantial, due to the dwindling of brokerage payments, it seems on a logical basis they must go one way or the other, toward higher loads for the investors or toward lower cost distribution methods. I favor the latter.

1/ ICI, "The Public's Attitude Toward Mutual Funds", prepared by National Analysts, Inc., (1971), at 2.

"And I don't think it is realistic to spend a great deal of time considering the former." 1/

This is an apt description of the situation. The fund industry's virtually total reliance upon incentives to "sell " fund shares has not forestalled a state of extended net redemptions; and there are no clear signs that the situation is likely to improve under the present marketing strategy. If anything, the sales picture may become even more difficult as the competition from other financial products becomes more intense and changes in brokerage practices and the erosion of the underwriter's spread prevent any increase in selling rewards for retailers. 2/ At the same time, shareholders sometimes do not receive proper service and in other cases, as we have noted, an investor may be compelled to "pay sales charges designed to cover selling efforts that he does not want, does not need, and does not get." 3/

We believe that mutual fund shares could not be sold effectively under a system of full retail price competition in the present distribution environment; nor is it likely that the public would significantly benefit from an attempt to institute such a system without an appropriate foundation having first been laid for it. As Professor Paul A. Samuelson commented in 1969:

> "[W]hen we are dealing with an industry like the securities industry, which is recognizably 'affected with public interest' and in which imperfections of knowledge will inevitably exist in some degree for everyone, and inexorably exist in greater degree for the small investor, all the principles of economics tell us that laissez-faire -- leaving it to competition of the marketplace, which will not be the free and perfect competition of the economics textbook marketplace -- cannot be counted upon to bring down excessive selling charges." 4/

Eliminating the sales "push" before there has been an opportunity to develop a demand "pull" could seriously harm the mutual fund industry.

1/ Tr. 2272.

2/ Logic, of course, suggests that the redemption situation will eventually stabilize, but whether, under existing regulatory constraints, the industry will be likely to move into another period of explosive growth of the net asset base through heavy net sales is certainly not clear.

3/ Mutual Fund Report at 221.

4/ Hearings before the Senate Committee on Banking, Housing and Urban Affairs on S. 34 and S. 296, 91st Cong., 1st Sess. 54 (1969).

As noted above, Professor Wallich cautioned that an immediate move to negotiated sales loads might increase net redemptions. 1/ He added that:

> "The need of the economy for equity capital also requires consideration, and at a time when stock issues are increasing while individual investors are leaving the stock market it would be wise to go slow in measures that might have the effect of further reducing the supply of equity money." 2/

Such a demand "pull" might be established by educating a much broader segment of the public concerning mutual funds, and accustoming more people to ownership, or at least considering ownership, of fund shares. As the OER Report put it:

> "[T]he deterrent to competition in sales loads is an absence of investor knowledge of the available alternatives. Elimination of Section 22(d) by itself will not change that." 3/

However, this educational process cannot be accomplished overnight.

3. Gradual Program Designed to Improve the Competitive Environment, With a Continuation of Retail Price Maintenance, But With the Ultimate Goal of Retail Price Competition.

The Division recommends a multifaceted program which would enable the Commission to deal with many of the more troublesome features of fund distribution now without immediately uprooting the existing retail price maintenance concept of Section 22(d). This program would

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1/ Page 71, supra.

2/ Written comment of Henry C. Wallich, at 5.

3/ OER Report at 251.

help the industry move to a stage where it might be able to adjust to full price competition by easing somewhat the regulation under Section 22(d) without, at least initially, basically changing the distribution system.

We recommend that the Commission immediately exercise its existing administrative authority to permit increased price variations in mutual fund sales loads under regulated conditions. One of the most significant of these actions would be an amendment to Rule 22d-1 permitting wider use of discounts in the sale to certain groups. Other important measures would include removal of certain of the existing restrictions on advertising, and a program to modify the Statement of Policy to allow more precise measurement and illustration and thus, greater understanding, of fund investment results. These steps will promote increased sophistication among investors and thereby gradually lessen the need for intensive personal selling efforts. By the same token, such sophistication, coupled with the availability of opportunities to purchase fund shares at lower than usual sales loads in certain circumstances, should lead to greater price elasticity and significant cost savings to investors -- an important change from the present environment. All of the actions which we recommend be taken at this time would be within the Commission's exemptive and other administrative power.

We also recommend that the Commission request the enactment of legislation which would authorize the Commission, if and when it deems appropriate, to introduce retail price competition in the mutual fund industry through administrative actions. This legislative action should be taken now in order to provide the Commission with stand-by authority to move the industry in this direction by removing the inhibitions against competitive pricing at the retail level. We would not, however, recommend the exercise of such authority to require retail competition until such time as the Commission might be able to satisfy itself that the preconditions for more effective price competition have been successfully established or the industry has demonstrated such an undue lack of willingness voluntarily to experiment with the flexibility we propose that it becomes clear that further regulatory action is needed.

It is important to note that our approach relies in major part upon the use of the Commission's existing rulemaking, interpretive and exemptive powers, and that legislation would be required only to implement the later stage of the program. Under such an administrative approach, the Commission could begin immediately to take steps which would permit price sensitivity and greater understanding of the fund concept to develop. Resulting benefits to investors -- and to the industry -- can be available now.

VI. RECOMMENDED PROGRAM

The Division recommends that the Commission take the following actions to modify the mutual fund distribution system. Some of these recommendations, such as those concerning advertising and grouping, have already been the subject of extensive public comment and deliberation and are set forth in action-oriented form. Others, however, are new, and their ramifications are discussed in somewhat more detail.

A. Measures Designed to Encourage a Degree of Voluntary Price Competition

1. Steps to Permit Funds to Communicate More Effectively With Investors

a. Advertising.

As previously indicated, the ICI study seems to demonstrate that the majority of Americans are unfamiliar with mutual funds. It hardly needs to be said that an important element in establishing a demand "pull" for funds is to acquaint more people with the existence and nature of the product. Hence, funds must communicate their message more effectively to the public on a mass basis. The Commission's Rule 135A under the Securities Act already contains liberal provisions for generic fund advertising, which were adopted with this objective in mind.

However, making more people aware of the fund concept generally will not by itself lead to the development of a demand "pull". It is also necessary that persons become sufficiently interested in one or more particular funds to request the fund's prospectus and inform themselves of its characteristics, without having the information "pushed" on them by a salesman. In order to achieve this goal, the Division recommends that certain of the existing restrictions on individual fund advertising contained in Rule 134 be eased, subject of course to the basic policy against inviting persons to buy securities until they have had an opportunity to examine the prospectus.

In connection with the mutual fund distribution hearings, a release proposing, *inter alia*, an amendment to Rule 134 to permit greater flexibility in investment company advertisements was published for comment on January 17, 1973.[1/] Upon analysis of the public comments, we

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1/ Investment Company Act Release No. 7632.

recommend that the Commission amend Rule 134 to make fund advertising more informative by permitting the inclusion of certain objective information. Our recommendation is also designed to make such advertising more interesting by permitting the use of certain pictures as well as other attention-getting devices. In addition, the amendment would allow the presentation of certain objective information concerning the adviser, thus focusing greater attention upon the adviser. Nonetheless, the importance of the prospectus would continue to be emphasized, and the release would make clear that this amendment is not intended to indicate any change in the Commission's views with respect to general publicity concerning offerings subject to the registration requirements of the Securities Act of 1933. In addition to these important changes, our proposal includes codification of certain previous interpretations. More specifically, we suggest that Rule 134 be amended as follows:

1. The following items would be permitted in a fund's tombstone advertisement for a registered company:

(a) the name of the investment adviser;
(b) the logo, corporate symbol, or trademark of the fund and its adviser; and
(c) designs or devices or an attention-getting headline not involving performance figures.

2. In addition, if (1) the fund's registration statement has become effective and (2) the advertisement also includes either a legend directing the reader to examine the prospectus for information on charges and fees and emphasizing the importance of reading the prospectus, or a coupon for use in ordering a prospectus which includes such a legend, the following items would be permitted in an advertisement:

(a) a description of the fund's investment objectives and policies, services, and method of operation;
(b) identification of the fund's principal officers;
(c) the year of incorporation or organization or period of existence of the fund and its adviser;
(d) the fund's aggregate net asset value;
(e) the aggregate net asset value of all registered investment companies under management of the adviser, whether or not in the same complex; and
(f) pictorial illustrations (not involving performance figures) contained in the company's prospectus.

3. Joint tombstones for two or more funds having the same investment adviser or principal underwriter would be permitted.

4. The term, "principal officers", would be defined for purposes of the rule.

b. Portrayal of Performance

Arousing the public's interest in mutual funds through more effective advertising is only a first step toward cultivating a more competitive environment for the distribution of fund shares. If a climate is to be developed where funds will be "bought" instead of "sold", potential investors must have an opportunity to learn more about a mutual fund investment from sales literature without the assistance of a salesman -- or at least, with less assistance than salesmen should now provide. Greater investor understanding and more meaningful comparisons of past investment returns, risks, and costs, and their effect upon investment returns, could lead to greater competition to improve the features which make up the mutual fund package -- by improving management services, reducing costs, and offering additional ancillary services.

The methods currently used for portraying investment results, which are prescribed in the Commission's Statement of Policy, 1/ do not facilitate meaningful analysis and comparisons, 2/ and many investors are not provided with information adequate to give them an understanding of the long-term nature of a mutual fund investment or of the risks involved in purchasing a particular fund's shares. 3/ The record developed during the hearings clearly indicates the desirability of revising the Statement of Policy to provide more meaningful information on fund investment results. We are not convinced that improvements in mutual fund distribution or the competitive environment would be an immediate and direct result of such an effort, but, in the long run, such changes leading to a more informed investor should also provide a basis for more effective price and product competition.

1/ The Statement of Policy sets forth guidelines to assist issuers, underwriters, and dealers in understanding what types of advertising and sales literature might violate statutory standards. It has not been revised since 1957.

2/ The participants in the Panel Discussion on Performance Measurement and the Statement of Policy were in general agreement on this matter. (Tr. 1622-1817)

3/ The return an investor receives from a variable annuity also depends to a large extent on the investment results achieved by management. Thus, it also is important that prospective investors in variable annuities have an understanding of the results which might be obtained from an investment in a variable annuity separate account.

Therefore, the Division recommends that the Commission propose a revision of the Statement of Policy to permit improved portrayal of fund investment returns, risks, and costs.[1/] Briefly stated, our suggested additions to the Statement of Policy would utilize four sample charts for performance portrayal which would:

(1) Portray investment results on a total return basis, including a single figure expressing a compound rate of return, which would state the result of investing distribution income, dividends and capital gains over a ten-year period, provided that certain conditions are met. Specifically, variations in the return and the relative effects of income and appreciation would have to be indicated. The return would have to be shown both excluding and including sales charges and expense deductions in order to show the effect of such charges on returns;

(2) Compare individual fund investment results over a ten-year period with a market index on semi-logarithmic charts of standard dimensions. The comparisons would be on a year-by-year and market-high to market-low basis; and

(3) Allow investors to analyze and compare the investment returns, risks, expenses, and tax charges of variable annuities during the accumulation or pay-in period.

SUMMARY- Measures to Improve Communication With Investors

If funds are to establish a demand "pull" they must be able to communicate their message more effectively. To this end, we recommend liberalization of the advertising restrictions in Rule 134 in order to: (1) permit the use of attention-getting devices and designs to allow fund advertising to be more interesting; (2) permit the inclusion of more objective details about the fund to allow fund advertising to be more informative; and (3) permit joint tombstones and more objective information about the adviser, placing greater emphasis upon the adviser. As proposed, such advertisements also highlight the importance of reviewing the prospectus prior to making an investment decision.

1/ A more detailed explanation of our suggestions for revising the Statement of Policy will be set forth in the release requesting public comment on proposed sample charts for the portrayal of investment performance which would supplement those presently permitted under the Statement of Policy.

We also recommend that steps be taken to make sales literature more informative by permitting meaningful comparisons of past investment returns, risks and costs and putting beneficial competitive pressure on funds with respect to costs and services. Funds must be able to show their investment results to investors in a straightforward way that makes risks and rewards immediately clear. To accomplish this, the Commission's Statement of Policy, which prescribes methods for portraying investment results, should be revised to permit sales literature which would: (1) portray investment results on a total return basis; (2) compare fund results over a ten-year period; and (3) foster greater understanding of variable annuity costs and investment results.

2. Measures Designed to Introduce More Price Variations into the Sales Load Structure.

Although we are of the view that retail price maintenance must be retained, at least for the present, we believe it is imperative that more variations be permitted in the mutual fund price structure at this time. Such variations could lead to significant economies and efficiencies in fund distribution; enable funds and their underwriters to eliminate certain inequities now experienced by some fund investors; and tend to encourage price sensitivity among investors by familiarizing them with the notion that a particular fund's sales charge is not necessarily uniform.

Industry representatives argue that retail price competition would lead to decreased, rather than increased, sales of mutual fund shares. The premise of their position is the contention that most people will not invest in a mutual fund unless the investment is explained to them by a salesman in a lengthy -- and costly -- interview, and this service must be paid for in the sales load. Yet, they argue, if other salesmen who provide little or no selling service are able to offer the same shares at lower sales loads to customers who have first received the necessary selling service from salesmen charging a higher sales load, the latter will be deprived of compensation for their efforts because the customers will make their purchases from the discount retailer. Thus, the argument runs, salesmen will be discouraged from

engaging in the necessary primary sales efforts and ultimately fewer people will buy mutual funds. 1/

The program recommended by the Division is designed to meet this argument by avoiding a sudden and involuntary end to retail price maintenance. The price variations proposed for initial action should lead to competition, but mainly among underwriters rather than at the retail level. Further, most of the variations would be available only at the option of a fund or its underwriter. In other words, a fund complex could, in general, offer the price variations so long as, and to the extent that, it found such action beneficial. A fund which found that dealers were discouraged from promoting its shares, and that as a result its sales were declining, could remedy the situation by ceasing to make available most of the opportunities for purchasing shares at less than a full sales load. Finally, it should be emphasized that the introduction of price variations into the sales load structure would not be occurring in a vacuum. As already explained, other measures also should be taken to help stimulate broader interest in, and understanding of, mutual funds. Therefore, it is reasonable to anticipate that many of the sales at variations in the sales charges will represent not diversion of income from regular retail dealers, but rather sales which would otherwise not have taken place at all.

a. Expanded Group Sales

Rule 22d-1 presently permits investment companies to offer group discounts on the sale of shares to "any person". In addition to individuals, the term "any person" includes corporations, qualified employee retirement plans, and certain other entities. However, it does not include-- and hence quantity discounts may not be extended to -- groups of individuals who combine their purchases in order to reach a breakpoint.

In December 1972, the Commission proposed to amend Rule 22d-1 to relax partially the restrictions upon discounts for groups. 2/ That proposal is still pending; consideration of whether to adopt it has been deferred in connection with the current mutual fund distribution project. We believe that the rule amendment should now be adopted, subject to certain modifications. In brief, we suggest that Rule 22d-1 be amended to permit -- but not require -- sellers of fund shares to offer discounts to the following additional groups, provided that in each case the group also satisfies uniform criteria selected by the issuer relating to the realization of economies of scale in sales effort and sales-related expense:

1/ Of course, mutual fund salesmen already must accept the risk that investors whom they have introduced to mutual funds will make future purchases elsewhere; it appears that many no-load investors first became familiar with the fund concept through load fund salesmen. (Testimony of Donald Samuel, Executive Vice President of the No-Load Mutual Fund Association, Tr. 434; and testimony of John L. Asling, pp. 73-75, supra.)

2/ Investment Company Act Release 7571, December 21, 1972. In the same release the Commission withdrew a 1968 proposal dealing with this subject.

(1) All employer-employee groups. This would be a modification of the present exemption for employer-employee groups, which now applies only to those which are tax-qualified under Section 401 of the Internal Revenue Code; and

(2) Any organized group of individuals which has been in existence for at least six months and has some purpose other than buying mutual fund shares. This discount would be based on quantity. However, in order to limit the availability of quantity discounts, at least in the context of the present amendment, such discounts would be specifically denied to certain groups of individuals: credit card holders of a credit card company or other business concern, policyholders of an insurance company, customers of a bank or broker-dealer, or clients of an investment adviser. The Commission might narrow or expand this listing by further amendment if experience shows that it would be appropriate.

With respect to the requirement that the group discounts be based upon economies of scale, the Commission has already adopted a relaxation of the confirmation requirements in Rule 15cl-4 under the Securities Exchange Act so as to permit cost savings in the case of certain group transactions. 1/ Such a relaxation is consistent with the provision in our recommended revised amendment to Rule 22d-1 to permit issuers to specify criteria relevant to the realization of economies of scale in sales effort and sales related expense.

It should be noted that, except for that portion of the proposed amendment to Rule 22d-1 which would make possible the sale of fund shares at a discount to non-tax-qualified employee plans, the industry is generally opposed to the grouping proposal. Members of the industry cite problems of suitability, discrimination, and "disorderly distribution." However, we believe that the core of the industry's objections is a fear that the broad availability of relatively low group prices might discourage retailers from making an effort to sell fund shares on an individual basis. Obviously, the extent to which this would occur cannot be predicted with certainty until the experiment has begun. In our judgment, however, it is unlikely that retailers would be discouraged from exerting sales efforts to any significant degree beyond that to which they are already discouraged. 2/ In any event, the Division sees no justification for confining the availability of the group discount to employer-employee relationships, and we believe that the grouping

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1/ Securities Exchange Act Release No. 11025, Investment Company Act Release No. 8514 (September 24, 1974). In addition, the staff, pursuant to Commission authorization, has informed the Investment Company Institute that it would not object in connection with group transactions, if, *inter alia*, certain cost-saving modifications were made in the paperwork procedures required by Rules 19a-1, 20a-1 and 30d-1 under the Investment Company Act. Letter from Director, Division of Investment Management Regulation, to President, ICI, March 13, 1974.

2/ It is particularly relevant in this context to emphasize that group discounts would be optional for the issuer; a mutual fund which found that group sales were adversely affecting its regular retailers' sales could cut back or even eliminate such sales.

proposal we suggest would result in significant benefits for both investors and the industry. 1/

From the standpoint of investors, the proposal would provide an opportunity to avoid paying full sales charges by purchasing fund shares without a complete "bundle" of selling services. Obviously, financial counseling would not be as feasible in connection with group sales as it would be with individual sales. Presumably, paperwork and other dealings with the underwriter would be handled, in many cases, by the group's common remitter, and a particular investor may or may not find this to be as satisfactory as if it were done by a regular fund dealer. It would be up to the investor to decide if such differences in service are worth the savings in sales charge; the investor who feels he needs individual services presumably would not buy through a group. However, for the investor who finds that group service would be adequate, group discounts would present an opportunity to avoid paying for personal services which he does not need or want and, very often, also does not get.

1/ In the future, as the industry moves to a more competitive price conscious environment, it may be appropriate to provide quantity discounts to any group whose combined purchase results in economies of scale, even if the group has been organized solely to pool orders for mutual fund shares, since the price differences would be based upon differences in cost and hence would not be unjustly discriminatory. Such unrestricted grouping would, of course, be similar to that which prevailed before 1958, but it would be permitted under vastly different competitive circumstances.

Ultimately, the existence of expanded opportunities for group discounts might benefit even those investors who buy on an individual basis by stimulating price and product competition among fund wholesalers or complexes. At the present time, much of the competition among mutual funds seems to take the form of ever-increasing efforts to encourage dealers to "push" funds harder. However, a fund complex which sees its competitors successfully marketing to groups might respond by attempting to make its own individual sales program relatively more attractive, through such measures as improved service to shareholders or even lower sales loads.

Retailers, wholesalers and complexes themselves also could benefit from opportunities for expanded group sales. As various civic, social or business organizations inform their members of opportunities for group purchases, people who were previously unaware of funds will be introduced to the concept; ultimately, such expanded awareness might lead to increased individual sales. In addition, the easing of the present restrictions on grouping, together with the cost savings which group sales would make possible for underwriters, will render it feasible for mutual funds to experiment with new mass-marketing strategies. Therefore, if the expanded opportunities for group sales do lead to some reallocation of selling effort, in the long run this should result in wider, more economical and more efficient distribution of mutual fund shares. Although some fund retailers might actually be hurt if they are not able to sell effectively to groups, the net effect on the distribution system -- underwriters, wholesalers, retailers and front line salesmen -- should be beneficial.

Moreover, the proposed grouping rule would be consistent with the Commission's historic application of Section 22(d). The basic policy of retail price maintenance would be retained, since the rule would introduce no price competition among retailers with respect to the shares of any particular fund. Underwriters would not be deprived of any commissions and, of equal importance, they would retain complete control over their distribution systems; no fund complex would be required to offer group discounts. Finally, there would be no unjust discrimination among investors because differences in sales charges would relate to differences in both costs and services.

b. Unsolicited Purchases

Although expanded opportunities for group sales should lead to some increased economies and efficiencies in mutual fund distribution, grouping is insufficient, by itself, to remedy one of the inequities in the present mutual fund distribution system. This is the problem of the unsolicited individual investor, who decides upon his own initiative to purchase mutual fund shares. Broadly speaking, there are two types of unsolicited load fund purchasers: new investors who decide to purchase shares of a particular load fund for the first time without ever having consulted a salesman, and "repeat" investors, i.e., persons who have previously purchased fund shares, usually upon the advice of a salesman, and then decide, by themselves, to purchase additional shares of the same fund. Unsolicited repeat investors are frequently "orphaned" accounts; that is, the dealer who originally sold them their fund shares has died or gone out of business.

Under present practice, an order from an unsolicited investor -- whether new or repeat -- must be routed through a retailer; if the customer does not know a dealer who handles the shares being purchased, the fund's management might recommend one. 1/ Thus, the dealers receive -- and the unsolicited investor pays -- a full sales commission, notwithstanding the fact that the customer might have had little or no contact with the dealer before deciding to make the purchase.

Manifestly, it would be desirable to permit such customers to receive price reductions reflecting the absence of selling effort with respect to their purchases. However, simply permitting mutual funds to reduce or eliminate sales loads for all customers who claim to be unsolicited would present serious practical difficulties. Particularly with respect to new investors, a customer might receive full selling service from one dealer, then place an ostensibly unsolicited order with another dealer, thus depriving the first dealer of compensation for his efforts. This possibility that retailers could, by itself, discourage selling efforts, and thus impair the fund distribution system. These

1/ See exchange between staff and, an official of F. Eberstadt & Co., Tr. 764-772, quoted in part at pp. 48-49, supra.

difficulties would be less likely to arise in the case of a repeat investor, since a person who buys additional shares of a fund may not need or receive extensive selling service. Nonetheless, providing reduced prices for repeat investors without limitation could have an adverse impact upon retailers' selling efforts with regard to new customers as well. A salesman who has no opportunity for additional commissions from follow-up sales may decide that the "one-shot" earnings from an initial sale do not justify an extensive effort.

The Division therefore recommends that the Commission propose to adopt an exemptive rule from Section 22(d) which would allow underwriters to provide for periodic "open seasons" during which persons (except holders of contractual plans) who have held shares of the fund for at least a a specified period, say, one year, could buy additional shares at a reduced price while shares were being offered at the same time to new investors at full sales loads.

Such a rule would, to a significant degree, allow unsolicited repeat investors to avoid paying unjustified sales charges, without at the same time disrupting the regular retail distribution system. That is, dealers would not be deprived of compensation for efforts expended in introducing new investors to the fund. Only persons who already own shares of the fund would be eligible for the reduced price. A waiting period such as one year, before an investor becomes eligible for the privilege, would discourage customers from taking unfair advantage of a salesman by placing a small initial order with him, then buying more shares directly from the underwriter at a lower price.

It is true that "open seasons" would deprive dealers of opportunities to earn sales commissions from follow-up sales, and this could discourage some dealers from engagingin efforts to introduce new investors to the fund. However, the extent to which this occurs should be minimal,

assuming that sales loads are high enough to provide salesmen with reasonable compensation for each sale. In other words, if salesmen receive enough compensation from a sale, it should not be necessary to offer the salesman the prospect of additional unrelated and perhaps unearned compensation from future purchases by the customer. In any event, since an open season also would not be mandatory, but would be entirely at the discretion of the fund and its underwriter, if it were found that "open seasons" were interfering with dealers' selling efforts, the fund could cease offering them. In the alternative, the fund could impose more stringent limitations upon the amount of shares which could be purchased at the discount than would be imposed by the rule itself; the Division contemplates that at least at the outset the rule would limit an "open season" purchase to an amount not in excess of the amount of shares already owned. 1/

An "open season" proposal should have other features as well, designed to limit, insofar as possible, the number of repeated investors paying unjustified sales loads. 2/ The most important would be adequate notice to shareholders of an "open season." If "open seasons" are planned at regular intervals, it is contemplated that this fact would have to be disclosed in the prospectus. Otherwise, appropriate notification of the "open season" would have to be mailed to shareholders. As a further

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1/ After the rule has been in effect for a period of time, experience might show that it is unnecessary to have a legal maximum on the amount of shares which can be purchased in an "open season," and any such maximum can be left to the sole discretion of the fund and underwriter.

2/ Holders of contractual plans would be required to pay the regular sales load on purchases made pursuant to the plan notwithstanding an open season, since they specifically agreed to pay such charges when they purchased the plan.

safeguard, we also contemplate that all money received from shareholders during the "open season" would have to be invested at the reduced price. 1/

A different question is presented with respect to reduced prices for unsolicited new investors. We do not recommend that the Commission adopt an exemptive rule permitting such discounts. In the Division's view, the likelihood that dealers could be deprived of compensation for their services, and that fund distribution might thus be impaired, outweighs the argument in favor of providing price reductions for genuinely unsolicited new investors. Furthermore, any unfairness inherent in requiring

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1/ Certain mutual funds have previously indicated interest in making special no-load offerings to repeat investors for limited periods of time. For example, last year the Manhattan Fund, Inc., requested a no-action position to the effect that it could make a special no-load offering of its shares to its existing shareholders for one month only. However, the Fund represented that, during the period of the special offering, the fund's shares would not be offered to other persons. Letter from Chief Counsel, Division of Investment Management Regulation, to James H. Ellis, October 31, 1973.

Even more recently, the Channing Management Corp. made a special no-load offering of shares of three of its funds, which were formerly underwritten and managed by Equity Funding Corp., during the month of March, 1974, to persons who had been shareholders of record as of April 2, 1973, as well as to existing shareholders. The purpose of the special no-load offering was to encourage the return of former shareholders who had previously redeemed as a result of adverse publicity involving the parent of the former management company. During the period of the special offering, all other sales (except for contractual plans) were suspended.

It might be noted that, although both Manhattan Fund and the Channing Funds suspended regular sales during their special offerings, we are now of the view that such action is not necessary. We do not believe that unjust discrimination would necessarily occur if repeat investors, receiving no selling service, were excused from paying the full sales load while new investors, who presumably do receive full selling service, were required to pay for it.

See also Rule 22d-2 under the Investment Company Act which, in permitting a mutual fund to allow its shareholders to reinvest, at no load, is an example of shares being sold without a sales charge to repeat investors where no selling effort -- and, in fact, no salesman -- is involved.

such investors to pay a full sales load should be reduced to the extent that at least some persons who, on their own initiative, select a particular fund, choose a no-load fund. On the other hand, we also recommend that the Commission indicate a willingness to consider individual applications for exemptions to permit underwriters to reduce or eliminate sales loads for unsolicited new investors, if underwriters are able to forumlate methods for overcoming the practical difficulties and can demonstrate that such price reductions are in the public interest and consistent with the protection of investors.

c. Purchases of Fund Shares in Combination With Other Financial Products Distributed By the Same Principal Underwriter

A considerable portion of the sales charge on a mutual fund covers the costs of initially soliciting the customer, ascertaining his financial needs, and counseling him. However, if a retailer sells fund shares to an investor to whom he has previously or contemporaneously sold some other financial product, such as insurance, it is clear that much of the necessary solicitation and financial counseling will already have taken place and need not be repeated in connection with the sale of the mutual fund. It is desirable to recognize such cost savings and allow fund distributors to pass them along to investors. 1/

This principle is already well recognized. For example, Rule 22d-1 permits volume discounts to be based upon the aggregate purchase of shares of different funds in the same complex. The same rule also permits volume discounts to be based upon the aggregate quantity of shares previously purchased, together with new purchases, of different funds in the same complex. 2/ The Commission has also granted individual exemptions to permit insurance or fixed annuity proceeds or cash values to be invested, without a sales charge, in variable annuities issued by the same company. 3/

1/ This seems particularly appropriate in view of the increasing diversity in the mutual fund salesman's product mix. See pp. 23-27, supra.

2/ In Westminster Bond Fund, Inc., et al. Investment Company Act Release No. 8204, January 30, 1974, the Commission granted an individual exemption permitting the dividends of one fund to be invested in shares of another fund in the same complex without a sales charge.

3/ See, e.g., ITT Variable Annuity Insurance Company Separate Account, Investment Company Act Release No. 5841 (October 14, 1969), and The Franklin Life Insurance Company, et al., Investment Company Act Release No. 6616 (July 14, 1971).

More recently, the Commission has permitted variable annuities to be purchased under these circumstances where the sales charge is merely reduced instead of eliminated, 1/ and the staff, pursuant to delegated authority, has permitted reduced sales loads to be applied where mutual fund shares are purchased with the proceeds of insurance issued by a company in the same complex as the fund. 2/

There are, of course, certain dangers associated with combination discounts. First, underwriters might be tempted to use mutual funds as "loss-leaders." That is, the fund shares might be offered at non-compensatory sales loads, while excessive sales charges are imposed for the other non S.E.C.-regulated product in the package. Not only would this be misleading to investors, but it would represent unfair competition against distributors of other mutual funds. Moreover, we should point out that combination packaging is of the most benefit to large underwriters which distribute a wide variety of financial products.

However, neither of these disadvantages appears to outweigh the savings that might be possible through appropriate combination packages. The Division therefore recommends that the Commission carry the principle of combination discounts somewhat farther than has been the case to date, and indicate a willingness to consider exemptive requests along the lines discussed below. 3/

We propose that underwriters be permitted to offer reduced or eliminated sales loads on mutual fund shares where the investor has (1) previously or contemporaneously purchased (2) from the same retailer (3) certain other types of investment products (including but not limited to insurance) 4/ (4) which are available at a separately stated price and which are (5) distributed by the same principal underwriter or a company affiliated

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1/ The Mutual Benefit Life Insurance Company, Investment Company Act Release No. 8008 (September 25, 1973).

2/ Connecticut General Life Insurance Company, et al., Investment Company Act Release No. 7570 (December 20, 1972).

3/ In the future, it may be possible to develop an exemptive rule in this regard, but before doing so, further experience with individual situations is required.

4/ However, it should be noted that where one of the products in the package is insurance, difficulties might be encountered under the laws of some states. For example, some states might regard discounts on such combination packages as unlawful rebates of insurance premiums, or "tie-in" sales. In addition, although price differences based upon cost savings seem justified, some states might view any price differentials on the same product as unlawful discrimination. Obviously, any combination package which includes insurance could be sold only in those states which permit it.

with such underwriter. 1/ The fund shares might be purchased with the proceeds of an earlier investment, or they might represent an additional investment on the part of the customer. In order to ensure that the other product is in the nature of an investment which requires some of the same type of selling service as mutual funds so that cost savings could be realized when the two products are sold to the same person, we would propose to require that the other product be either a security registered under the Securities Act of 1933, life insurance, or fixed annuities.

Such an approach to combination packages should afford two basic advantages. First, it would permit economies and efficiencies in selling effort to be passed on to investors in the form of lower sales loads.2/

1/ Heretofore, the exemptions permitting price reductions where variable annuities or mutual fund shares are purchased in combination with another financial product (i.e., insurance), have generally been limited to cases where the variable annuities or fund shares are purchased with the proceeds of insurance previously acquired. (But cf. Mutual Benefit Life, n. 1, p. 98, supra, where quantity discounts for variable annuities were permitted even though some portion of the purchase necessary to reach the breakpoint might be allocated to fixed annuities.) However, it seems that the policy arguments in favor of combination discounts are equally valid where the other financial product represents an investment other than insurance, and where it is purchased contemporaneously rather than previously. In all such cases, savings in selling expenses will be possible which can properly be passed on to the investor.

It might be noted that, in a recently granted exemption, two mutual funds, Aetna Fund, Inc., and Aetna Income Shares, Inc., and their principal underwriter, Aetna Financial Services, Inc., which is a wholly-owned subsidiary of an insurance company, Aetna Life and Casualty Company, have been permitted to offer shares of the funds at half the usual sales charge to customers whose purchase represents the application of proceeds of insurance or annuity contracts issued by Aetna or a company controlled by Aetna Investment Company Act Release No. 8360, May 28, 1974.

2/ It might be noted that combination discounts would have a somewhat different theoretical basis from that of discounts for repeat investors. The latter is premised upon the supposition that the sales "push" would be replaced by a demand "pull", with the customer taking the initiative in order to obtain a lower price. Combination discounts, however, would be based not upon an elimination of the sales "push," but merely upon more efficient delivery of the selling service. Quantity discounts for groups are based upon a combination of these two theories; that is, part of the cost saving results from the fact that less selling service is supplied to the customer, and part from the fact that the selling service which is supplied is delivered more efficiently i.e., on a group basis.

Second, combination discounts would provide underwriters with an additional opportunity to experiment with new distribution strategies, based upon price. 1/

Of course, restricting the availability of the exemption to cases where the mutual fund and other financial products are purchased from the same retailer and distributed by the same underwriter (or an affiliate thereof) would tend to limit the use which could be made of the exemption. Both qualifications appear necessary, however, at least at the beginning. In view of the considerable administrative difficulties inherent in basing combination discounts upon purchases of financial products distributed by different underwriters or retailers, it would not be practical to permit such discounts. 2/ The condition that

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1/ It is likely that at least some underwriters would be willing to engage in such experiments. For example, in a registration statement pending as of July 30, 1974 (No. 2-50412, filed March 13, 1974), the Bayrock Capital Preservation Fund, an open-end bond fund, proposes to offer a limited number of shares at a 4% sales load. However, the shares may be purchased only in $2,000 "units" consisting of certain quantities of the bond fund shares and shares of the Bayrock Growth Fund, Inc. The latter, which may be bought separately, has a sales load of 8.5% for the smallest purchases; the sales load for a combined "unit" would be 5.35%. Purchasers of "units" would be permitted to invest dividends of the bond fund in shares of the growth fund without a sales charge.

Additional evidence of the viability of combination packaging as a distribution technique is found in the fact that at least one no-load fund, the PRO Fund, Inc., is apparently being sold mainly by salesmen in combination with retirement plans or insurance. See testimony of G. Richmond McFarland, Jr., Tr. 406-07, 430.

2/ However, our reference to the administrative difficulties in this area should not be taken as a suggestion that the difficulties are insurmountable in all cases. In fact, in a recent case, because of special facts, a number of mutual funds in a fund complex and their underwriters have filed an application for exemption from Section 22(d) and Rule 22d-1 to permit tax-exempt organizations purchasing fund shares to receive volume discounts based upon previous purchases of one or more of the other funds, even though all of the funds are not distributed by the same underwriter. The application is based upon the fact that, until July 1, 1973, all of the funds did have the same underwriter (Vance, Sanders & Co., Inc.); shares of funds which are now in a different complex from the fund being purchased will be counted for purposes of the volume discount only if they were held by the purchaser on July 1, 1973. (File No. 812-3541).

the mutual fund shares be distributed through the same underwriter as the other financial product, or an affiliate of such underwriter, also would leave the funds and their underwriters in full control of the marketing of all combination packages which might affect them, while allowing the flexibility to design combination packages to meet the varied needs of investors and give the retailer more options in meeting his customer's needs.

Finally, to minimize the loss-leader possibility, each product in a combination package also should be available separately at a stated price, as noted previously. In determining whether to grant a particular application for exemption, the Commission could consider whether the sales charges on the separate products are realistic, and whether the price of the combined package reflects a genuine discount.1/

SUMMARY -- Measures to Introduce Price Variations

Rule 22d-1 permits quantity discounts to "any person," which term is defined to include corporations, qualified employee retirement plans, and certain other entities. The Division recommends adoption, with certain modifications, of an already published amendment to Rule 22d-1 to permit (but not require) discounts to: (1) all employer-employee groups; and (2) any organized group (with certain exceptions) which has been in existence for more than six months and has some purpose other than buying fund shares. Section 22(d) has also been interpreted to preclude a fund from making a special offer of its shares to existing shareholders at a sales load more favorable than that charged new investors. The Division recommends that the Commission propose a rule allowing such discounts for existing shareholders, subject to certain safeguards. The Division also recommends that the Commission indicate a willingness to consider individual applications for exemptions permitting reduced sales loads for unsolicited new investors, where the applicants are able to demonstrate that such an exemption would be in the public interest and consistent with the protection of investors.

In addition, the Division believes that the Commission should indicate a willingness to consider applications to permit underwriters to offer discounts to mutual fund purchasers who have previously or contemporaneously purchased, from the same retailer, another investment product distributed by the same underwriter. Such exemptions would permit cost savings to be passed on to investors, and permit underwriters to experiment with varied financial packages. They would also introduce price variations which in themselves could help cultivate price sensitivity among investors.

1/ Making each financial product in the package available separately would also help eliminate the possibility that the package itself could be regarded as a separate security which must be registered under the Securities Act of 1933. Cf. Investment Company Act Release No. 5510, October 8, 1969.

d. Exemption of Variable Annuities from Section 22(d)

Although registered separate accounts funding variable annuities are conceptually different from mutual funds, a variable annuity is a "redeemable security" and therefore within the purview of Section 22(d). However, for several reasons, Section 22(d) has little relevance to the marketing of variable annuities. To begin with, Section 22(d) is not needed to prevent dilution since variable annuities could not be sold at less than net asset value. Nor is there a possibility of "disorderly distribution". Each insurance company underwriter of a variable annuity can maintain the order of its own distribution system, since variable annuities are typically sold through vertically integrated "captive" sales organizations, and thus retail prices can easily be maintained on most sales even without a statutory requirement. 1/ Moreover, the nature of the product precludes the development of a secondary market. Variable annuity contracts are not generally assignable, and, even in cases where they might be assignable, they are nevertheless based upon the continuing life of a particular individual and thus do not lend themselves to public trading.

Therefore, the Division recommends that the Commission adopt a rule generally exempting the variable annuity industry from Section 22(d), provided that all prices or pricing formulas are described in the variable annuity's registration statement and prospectus. However, since Section 22(d) also seems intended to prevent unjust price discrimination, any such exemptive rule should require underwriters of variable annuities to justify any price variations on the basis of differences in costs or services. 2/ We do not suggest that the Commission attempt more specific regulation in this area because of the difficulty of anticipating all possible price variations. 3/ In any event, should experience indicate that unjust price discrimination is occurring in the sale of variable annuities, the Commission could undertake further rulemaking action at that time. 4/

1/ Section 22(d) does not preclude price competition between underwriters or complexes.

2/ In addition, as explained at pp. 131-32, *infra*, variable annuities would be subject to the NASD's maximum sales load rule.

3/ In other areas subject to Commission jurisdiction where price competition exists or is contemplated -- notably stock exchange commission rates -- the Commission has issued no regulations concerning discrimination.

4/ State laws prohibiting unjust discrimination in the sale of insurance might apply to variable annuity sales charges. However, even if such laws are held not to apply, insurance companies' experience in dealing with them should render insurance companies particularly sensitive to the need to avoid unjust discrimination. Allen Thaler, Senior Vice President of the Prudential Insurance Company of America commented during the hearings:

> "/A/s an insurance company we have dealt with these questions of price discrimination at the state level for many years. Every State in the Union has some kind of a law which prohibits price discrimination. And this is certainly one of the things we must consider in pricing our variable annuities, which is the product we sell." Tr. 1396.

We believe that significant benefits would result from a rule generally exempting the variable annuity industry from Section 22(d). Such a rule would enable insurance companies and underwriters to design and offer investment vehicles which relate sales charges to services offered and to take into account savings in selling effort and costs. This would result in additional price options for investors which could help to foster a competitive environment. Furthermore, insofar as variable annuities may be sold by independent broker-dealers, an industry-wide exemption from Section 22(d) could permit further price variations at the retail level and conceivably could result in a degree of price competition among individual brokers.

Because the Commission has issued numerous orders exempting variable annuities from Section 22(d) to permit them to reduce or eliminate sales charges under particular circumstances, 1/ it is particularly appropriate to consider a general exemptive rule 2/ which would provide administrative benefits by making it unnecessary for variable annuity issuers to file, and the Commission to pass upon, applications for any further individual exemptions.

SUMMARY -- Variable Annuities

With the Commission's approval, we will develop a rule to exempt variable annuities from Section 22(d) immediately. Such an approach is preferable here to the gradual approach which we are recommending for mutual funds, since the removal of mandatory retail price maintenance would probably not have any negative impact upon the distribution of variable annuities.

1/ Forty-five such exemptions were granted between July, 1969, and September, 1973.

2/ Although we are not prepared to argue that the Commission could exempt the entire mutual fund industry from Section 22(d) without additional authority, such a sweeping exemption for the variable annuity industry (subject to a prohibition against unjust discrimination) would seem to be consistent with the purposes of the Act, and within the Commission's authority under Section 6(c). This is because, as we have explained, the anti-dilution and orderly distribution purposes of Section 22(d) are largely inapplicable to variable annuities.

e. Price Flexibility in Brokered Transactions.

1. Sale of Fund Shares by One Person to Another Through an Agent.

aa. Background and the Situation Today.

The development of a secondary brokerage market 1/ for mutual fund shares has been effectively prevented by various provisions contained in the uniform sales agreements between principal underwriters and broker-dealers.

Such provisions generally require, inter alia, either that a broker-dealer refrain from acting as agent in the sale of shares to the public or, if it does act as agent, that it nevertheless maintain the public offering price. 2/

The Commission and its staff have consistently taken the position that Section 22(d) is inapplicable where an individual fund shareholder sells his shares through a broker to another person. 3/ In other words, there is no statutory requirement that the offering price in the prospectus be maintained in a brokered transaction. 4/

1/ As used herein, a secondary brokered market refers to a market where one individual sells shares to another, through an agent; it does not refer to a secondary market where dealers, acting as principal, purchase shares for their own account from shareholders, and then sell them to other investors.

2/ Contractual provisions of this kind are currently being challenged under the federal antitrust laws. See Haddad v. Crosby Corp., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶94,319 (D. D.C., 1973), probable jurisdiction noted sub nom. United States v. NASD, (October 14, 1974).

3/ Opinion of the General Counsel, Investment Company Act Release No. 87, March 14, 1971; Oxford Company, Inc., 21 SEC 681 (1946); letter from Director, Division of Corporate Regulation to Edward J. Esap, March 18, 1966; and letter from Chief Counsel, Division of Investment Management Regulation to George A. Bailey, Jr., April 24, 1973.

4/ In view of the fact that by definition the secondary brokerage market in a fund's shares is not part of that fund's primary distribution system, any differences in price that may occur between the secondary brokerage market and the primary distribution market cannot be said to be the product of a discrimination by the fund between similarly situated investors. Accordingly, we are in disagreement with the court in Haddad, supra at 94,106 insofar as that court reasoned that the Commission's prior pronouncements respecting the applicability of Section 22(d) to brokered transactions were somehow defective because those pronouncements failed to deal with the problem of discrimination between similarly situated investors.

The Court in Haddad also criticized the Commission's pronouncements concerning the applicability of Section 22(d) to brokered transactions on the ground that those pronouncements did not address the effect of brokered transactions at other than the stated offering price on the regulated distribution system. As we indicate in the text, infra, we do not think the existence of a brokerage market will have a material effect on the primary distribution system.

As a matter of sound regulatory policy, we think it appropriate to eliminate the kinds of contractual restraints on a secondary brokered market in mutual fund shares described above. While it is difficult to predict the actual impact of a limited secondary brokered market for fund shares, we do not believe it would disrupt the primary distribution system. Further, at the present time, and in the context of the Commission's total regulatory scheme respecting fund distribution, we think that there are sound policy reasons for permitting such a market. First, a secondary brokered market would introduce an additional possibility for price variations, thus helping to develop price sensitivity among investors. Secondly, such a market would provide investors and broker-dealers with some experience in secondary market transactions, thus providing important insight into whether a secondary dealer market could function effectively.

Accordingly, the Division recommends that the Commission request the NASD to amend its Rules of Fair Practice to prevent fund underwriters from providing in dealer agreements that fund dealers cannot also act as brokers in secondary market sales of fund shares at negotiated commission rates. 1/ In addition, if it appeared that funds were attempting to defeat the intent of such an NASD rule by restricting transferability of their shares in a secondary brokered market, we would recommend that the Commission propose a rule under Section 22(f) of the Act to prohibit such restrictions. 2/

We believe that provision should be made to help neutralize any adverse impact upon the funds' primary distribution systems, and to ensure that transactions in a brokered market do not injure existing shareholders. Thus, we propose that a mutual fund be permitted to impose a reasonable flat service

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1/ If the NASD declined to amend its rules in the manner requested, the Commission may effect the same result by acting under Section 15(c)(2) of the Exchange Act or Section 22(f) of the Investment Company Act. Section 22(f) prohibits open-end investment companies from restricting "the transferability or negotiability" of its securities unless such restrictions are described in its registration statement and are not "in contravention of such rules and regulations as the Commission may prescribe in the interests of the holders of all of the outstanding securities of such investment company."

2/ No exemption from Section 22(d) would be required to permit price competition in a secondary brokered market since as noted above Section 22(d) does not apply to brokered transactions in fund shares.

fee (the upper limit of which may be fixed by the Commission), when ownership of its shares is transferred. Such a fee would presumably cover the cost of recording the transfer on the fund's books, and might also include an amount to compensate the underwriter, at least in part, for the absence of any underwriter's spread on the sale. 1/ As a technical matter, the Commission could provide for this merely by stating in a release that it would consider the imposition of such a fee reasonable. If any fund imposed a fee higher than that which the Commission considered reasonable, the Commission could prohibit it by a rule pursuant to Section 22(f).

1/ It may be argued that the services performed by underwriters do not directly benefit investors who purchase shares from other individuals through a broker. However, mutual fund offerings, unlike new offerings of other securities, are continuous; therefore, persons who buy and sell shares in the secondary market do benefit indirectly from the underwriter's services, for example, advertising, in that the underwriter helps to create the continuing demand which is basic to the functioning of such a market. Therefore, they should help pay the cost of such services.

As previously indicated (p. 56, supra), F. Eberstadt & Co., suggested in its written and oral presentations that funds should be permitted to charge a transfer fee if Section 22(d) were eventually repealed. However, the company's representatives expressed the opinion that such a fee should be as high as 1-1/2%, and they indicated that they viewed one of its purposes as being the discouragement of a secondary market. By contrast, our suggestion of a transfer fee is not intended to inhibit a secondary brokered market, but merely to help ensure that all shareholders, regardless of from whom they purchase their shares, bear a fair share of mutual fund distribution costs.

We also propose a safeguard against the secondary brokered market functioning like a dealer market by making clear that brokers should not fill orders to buy or sell fund shares more than one full business day after such orders are received. 1/ This would ensure that the brokers engage only in the genuine matching of orders, and do not, in effect, maintain an inventory of buy or sell orders until "matching" orders are received. 2/

1/ Brokers would be required to inform both buyers and sellers that the price paid or received for shares in such a market might be different than if the purchaser had bought them in the primary distribution system, and the seller had redeemed them. Such differences could relate to more than the sales charge; they could relate also to net asset value. Since the price of shares purchased from the fund would be based upon their net asset value next computed after the order had been placed (Rule 22c-1), in a declining market the price of such shares might be lower than the price of shares purchased from another individual through a broker. Conversely, in a rising market, a seller of shares might receive more if he redeemed them. It would not appear possible for the Commission to require brokers to deliver prospectuses in the case of all secondary market transactions, although the broker would be required to do so under the Securities Act of 1933 if he happened also to be a dealer of the fund being purchased. Section 4(1) of the Securities Act states that the provisions of Section 5 (relating to, *inter alia*, the delivery of prospectuses) do not apply to "transactions by any person other than an issuer, underwriter, or dealer."

2/ There is, of course, a distinction between an inventory of orders and an inventory of shares, and maintaining an inventory of orders might not make one a dealer in securities. If it became necessary, however, to prevent such inventorying of orders, the Commission could adopt a rule, pursuant to Section 38(a) of the Investment Company Act, defining as a "dealer" a person who holds mutual fund orders for more than one full business day. A dealer (as opposed to a broker) would have to comply with both Section 22(d) and the forward pricing requirement of Rule 22c-1.

Finally, we would recommend that, if a rule under Section 22(f) proved necessary, it contain a provision permitting particular mutual funds, upon application, to be excused from the operation of the rule. That is, the Commission could issue an order permitting the fund to restrict the transferability of its shares so as to prevent their sale in a secondary brokered market if the fund could show that such a market in its shares had become so extensive and price-competitive as to present a significant threat to the fund's primary distribution system. 1/

bb. Would Professionals Participate in a Secondary Brokered Market?

Theoretically, matching orders could take place on a broad scale if, for example, large broker-dealers used computers to match buy and sell orders from their branch offices, or if brokers used a computer network to give them access to other brokers' buy and sell orders for a particular day. Such computer technology is already available. Some large broker-dealers may already possess the necessary equipment to enable them to match orders among their branch offices, and computer networks such as INSTINET could be used to link broker-dealers in a secondary brokerage market for fund shares. 2/

In determining whether or not to match orders, 3/ one consideration which might influence a broker-dealer's decision would be the demand for mutual fund shares. Another factor which a broker-dealer might consider in determining whether to engage in the matching of mutual fund orders would be, of course, the size of the fee which could be earned from this service. We anticipate that such fees would have to be fair

1/ Such a procedure would be similar to one presently set forth in Rule 17d-1, which generally prohibits investment company underwriters and affiliated persons of either the company or underwriter from participating in joint enterprises or arrangements or certain profit sharing plans with the company, unless the Commission has, upon application, granted an order permitting such activity.

2/ However, although broker-dealers who are not parties to mutual funds sales agreements are not bound by the restrictions challenged in Haddad, supra, there has not been matching of mutual fund orders to any significant degree. On the other hand, the absence of matching by non-contract dealers may be due to the fact that most investors are unaware that mutual fund shares can be bought and sold in this manner; if the Commission were to take the actions we suggest, the resultant publicity might lead to increased interest in a secondary brokered market.

3/ Some may argue that establishing a secondary brokered market would place brokers who are also fund dealers in a dilemma with respect to their fiduciary obligations to secure best price. Any such problems should be no different from those confronted by every broker-dealer in the industry today when, for example, their customers engage in transactions in over-the-counter securities in which the firms themselves are also making markets.

and reasonable. 1/ They would, of course, be fully competitive and brokers and customers could agree upon charges in accordance with the services actually rendered.

SUMMARY -- A Secondary Brokered Market

By its terms, Section 22(d) does not apply to brokered transactions. Nevertheless, no secondary market in mutual funds has developed because uniform sales agreements between underwriters and broker-dealers effectively prohibit such a secondary market.

The Division recommends that the Commission now act in this area and request the NASD to amend its Rules of Fair Practice to prohibit restrictions against a secondary brokered market. We also recommend that, if necessary, the Commission promulgate a rule under Section 22(f) to prevent funds from accomplishing the result presently obtained in sales agreements by restricting the transferability of their shares. However, steps should be taken to prevent a secondary brokered market from having an adverse impact on the primary distribution system. Specifically: (1) a fund should be able to impose a reasonable flat transfer fee; (2) orders should not be filled more than one full business day after they were received; and (3) a fund should be able to obtain an exemption from any rule under Section 22(f) upon a showing of a threat to its distribution system.

Development of a secondary brokered market would depend on demand for fund shares and the compensation available, which would be competitively determined. The fee for executing transactions in fund shares would have to be "fair" and fully competitive. Such a limited secondary brokered market would not disrupt the primary distribution system, and it would introduce possible price variations and provide insight into whether a secondary dealer market could function effectively.

1/ Article III, Section 4 of the NASD's Rules of Fair Practice requires that a brokerage commission for over-the-counter transactions be not more than that which is "fair . . . , taking into consideration all relevant circumstances including market conditions with respect to such securities at the time of the transaction, the expense of executing the order and the value of any service [the broker] may have rendered by reason of his experience in and knowledge of such security and the market therefor."

ii. Purchase of No-Load Shares Through a Broker Charging a Fee

Investment Company Act Release No. 7475, in outlining the issues to be considered in this proceeding, pointed out that:

> "[U]nder present administrative interpretations brokers and dealers have no direct incentive to recommend 'no-load' funds. . . . The imposition of any charge for recommending the shares or for effecting the purchase of such a fund, especially if the fund encourages or has knowledge of the practice, has been viewed as an impermissible deviation from the prospectus representations as to no-load status as well as a violation of Section 22(d)." 1/

In the release, the Commission went on to ask whether it should:

> "re-examine its present administrative interpretations in order to remove disincentives operating against recommending no-load funds [and] permit brokers and dealers to charge a normal stock exchange commission for recommending and effecting an investment in a no-load fund." 2/

There are policy arguments in favor of permitting a broker to charge a fee for services rendered in connection with purchases of no-load shares. First, such a fee would provide brokers who recommend no-load funds with payment at least somewhat comparable to that which they would have received if they had recommended an alternative investment, such as a blue-chip stock or a load fund. In other words, brokers would have less disincentive to consider no-load shares when determining what would be a suitable investment for a particular customer. Secondly, such charges on purchases of no-load shares would compensate brokers for services rendered when they do recommend no-load shares. Such services might involve selection and suitability determination and the preparation of forms.

1/ Page 9.

2/ Ibid.

On the other hand, in the past the staff believed that charging brokerage fees for effecting purchases of no-load shares might be fraudulent as well as a violation of Section 22(d). 1/ Although the NASD indicated that it was "not opposed to broker-dealers being compensated for their sales effort in connection with no-load funds," 2/ the NASD also expressed the view that brokerage fees on purchases of no-load shares should be permitted only if "funds availing themselves of broker-dealer services drop the 'no-load' label and inform the investors of the sales charges through the prospectus." 3/

The NASD's suggestion that funds being sold through brokers should not be permitted to represent themselves as no-load was based upon the argument that:

> "the designation of 'no-load' constitutes the backbone of the marketing strategies for those funds. If broker-dealers were allowed to make a charge for 'recommending and effecting' a sale, it would be misleading to characterize such a fund as a 'no-load'." 4/

Another argument advanced by the NASD was that, if a fund is sold through brokers charging a fee, all investors -- including those purchasing directly from the fund -- should be required to pay the same sales charge. The NASD claimed that such a result was required to avoid discrimination prohibited by Section 22(d), and it added that brokers would be unlikely actively to sell funds which could be purchased directly from the fund without a sales charge. 5/

1/ See, e.g., Investment Company Act Release No. 7475, quoted at p.112, supra; cf. letter from Chief Counsel, Division of Investment Management Regulation to Edward J. Costigan, November 27, 1973.

2/ Written comment of NASD, at 64. "[I]t is in the public interest that brokers be in a position to offer the greatest possible diversity of investment alternatives, including no-load funds," Id. at 65.

3/ Ibid. The NASD noted that "the compensation of broker-dealers for their continuing efforts on behalf of no-load funds is . . . a timely subject for inquiry," since the prohibition of reciprocal brokerage "removes existing incentives to broker-dealers to recommend such funds to their customers." Id. at 64.

4/ Ibid.

5/ Id. at 65.

The No-Load Mutual Fund Association said that, while a number of no-load funds have used the services of brokers and dealers for the distribution of their shares, most no-load funds prefer to deal directly with the customer without the interpositioning of a third party. 1/

The No-Load Fund Association said that its:

> "basic concern in this matter is the confusion which would arise in the minds of prospective investors who would find that the no-load mutual fund of his choice was in fact not a no-load fund. With the interposition of the broker and dealer, the direct marketing by no-load mutual funds would become even more difficult." 2/

Therefore, the No-Load Fund Association recommended that the imposition of any charge for recommending or effecting the purchase of no-load shares be permitted where a particular fund desires it, but that no regulation be issued concerning the subject. 3/ At the hearings, the No-Load Fund Association's Executive Vice-President, Donald Samuel, who is also President of the no-load Energy Fund, expressed his personal view as being somewhat different from that of the No-Load Fund Association. He said that a no-load fund should not "be distributed with a load and still be allowed to be called a no-load fund." 4/

Nonetheless, the Division believes that it would be proper for a broker -- acting independently of the fund -- to make a reasonable charge for services rendered in connection with the purchase of shares of a no-load fund, provided the customer is informed that he could order the shares directly from the fund without paying any sales charge. If the broker's charge is not required by the fund, no part of it is received by the fund, and it is something over which the fund has no control, it may be viewed as being separate and apart from the price of the fund

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1/ Written comment of No-Load Mutual Fund Association, at 17. However, certain no-load funds indicate in their prospectuses that shares may be purchased either directly from the fund without a sales charge or through brokers who will charge a fee, notwithstanding the fact that the legality of such charges has heretofore been unclear.

2/ Written comment of No-Load Mutual Fund Association, at 17.

3/ Ibid. The Association's position is apparently based upon the assumption that brokerage fees on purchases of no-load shares are legal, where the fund chooses to permit them.

4/ Tr. 478.

shares. Such a fee would be one which the customer would pay voluntarily to a third person in order to compensate him for certain services not offered by the fund. These characteristics distinguish such a charge from a sales load which is not only retained in part by the fund underwriter, but is mandated by the fund to cover the cost of the selling effort which is an integral part of the fund's distribution system. 1/

The Division recommends that we be authorized to respond to interpretive requests by indicating our view that a broker who makes a charge for services rendered in connection with effecting the purchase of shares of a no-load fund would be acting neither fraudulently nor in violation of Section 22(d), provided that the following conditions are met:

(1) The broker is acting independently (i.e., he is unaffiliated with the fund and has no formal or informal agreement with the fund or its investment adviser to distribute the fund's shares). The fund must not encourage brokers to make such a charge or give any special treatment to orders received through brokers. Otherwise, the charge would be regarded as a sales load; 2/

(2) The broker, as part of his normal description of the product, informs the customer that the shares could be purchased directly from the fund at no-load; and

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1/ Section 2(a)(35) of the Act defines "sales load", in part, as:

> "the difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer . . . , less any portion of such difference deducted for . . . administrative expenses or fees which are not properly chargeable to sales or promotional activities."

This view of the broker's charge as something distinct from a sales load would not permit a broker-dealer to make a similar charge on the purchase of a load fund. The public offering price of a load fund, unlike that of a no-load fund, includes a charge for selling service. Therefore, the imposition of a charge in addition to a sales load would be unjustified, since the broker-dealer in effect would be demanding double payment for his services. In contrast, where such a charge is made in connection with a purchase of no-load shares, it would cover services which are not otherwise paid for or provided.

2/ Although the fund must have no interest in or control over whether a brokerage fee is charged, the possibility of such a fee should be disclosed in the fund's prospectus.

(3) The charge is reasonable considering the size of the transaction and the extent of the services provided. 1/

To the extent the number of no-load funds increases, 2/ and to the extent that fund investors who need service are able to obtain such service from brokers in connection with purchases of no-load shares, additional price variations -- and indeed, opportunities for price competition -- will have been introduced into the mutual fund distribution system. In other words, mutual fund customers who are unable or unwilling to invest in a no-load fund without any assistance will not be limited to buying a load fund at a fixed sales charge; they will have the additional choice of paying a broker a competitively determined fee to assist them with the purchase of a no-load fund. The increasing availability of such an option could, itself, assist in cultivating price sensitivity among mutual fund investors.

SUMMARY -- Brokerage Commissions on Purchases of No-Load Shares

There are two basic policy arguments in favor of permitting brokers to make reasonable charges for services rendered in connection with the purchase of no-load shares: (1) doing so would provide brokers with an incentive to recommend no-load fund shares; and (2) doing so would compensate brokers for their services. On the other hand, both the Commission staff and the NASD have taken the position in the past that charging brokerage commissions is inconsistent with the designation, "no-load." Nevertheless, on balance, the Division believes it would be neither fraudulent nor violative of Section 22(d) to impose a reasonable charge for services rendered in connection with the purchase of no-load shares provided: (1) the broker is unaffiliated with the fund and has no formal or informal agreement with the fund or its investment adviser to distribute the fund's shares; (2) the broker advises the customer that the shares are available from the fund at no-load; and (3) the charge is reasonable in terms of the size of the transaction and the services rendered.

1/ The fact that the charge would be negotiable, and the customer would be aware that the shares could be purchased on a no-load basis would likely serve to control the size of the charge. It appears that certain brokers are charging, or propósing to charge, a flat "transaction fee" of approximately twenty dollars on purchases of no-load shares, regardless of the amount of the purchase. This would seem reasonable, because even on a relatively small purchase of $5,000 the fee amounts to only 0.4%.

2/ With the increasing popularity of cash management funds, most of which are no-load, the number of such funds is likely to increase significantly.

B. Recommended Legislative Proposals for Expanded Authority to Take Subsequent Administrative Actions

Most of the recommended price variations would be made possible by use of the Commission's authority to grant exemptions from Section 22(d). They would be available at the option of funds and their underwriters and, presumably, utilized to the extent deemed in the best interest of the distribution system. 1/

It is to be hoped that the industry will make full use of these opportunities proposed to provide for the cultivation of a more competitive fund distribution system. If, however, the industry unduly resists implementing the price variations which would be necessary first steps toward retail price competition, the Commission should have the authority to make such price variations mandatory rather than merely optional. There is, of course, a necessity to avoid disruption of the fund distribution system. However, an exaggerated fear of disorderly distribution should not be permitted to form a pretext for avoiding the introduction of price competition which, while perhaps difficult and even unprofitable for particular funds and their underwriters, and certain dealers, would be to the benefit of investors and the fund industry generally. Therefore, we recommend that the Commission ask Congress to amend Section 22(d) to provide the Commission with adequate authority to require price variations such as those we have described. Such authority could be exercised upon a finding that the industry had failed to move toward price competition voluntarily, and that such failure was not justified by the likelihood of serious adverse consequences for the fund distribution system.

After improved mass communication with investors and limited price variations (whether introduced voluntarily or by administrative requirement) have accomplished their goal of helping to foster a more competitive distribution environment, it then would be appropriate to consider whether other, more far-reaching modifications of the retail price maintenance system, including, ultimately, the establishment of retail price competition in the sale of fund shares both in primary distributions and a secondary market, might be appropriate. 2/ Again, however, the Commission would have full administrative

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1/ The only price variations which would not be based upon exemptions from Section 22(d) -- and thus would not be optional with funds and their underwriters -- are those involving transactions executed by brokers. Thus, funds would have no power to prevent brokers from matching orders to buy and sell shares in a secondary market, nor would funds have any control over the charging of brokerage commissions for effecting purchases of no-load shares.

2/ At some point, it might be useful to consider promulgating a precise timetable for the establishment of full price competition. Clearly, however, the formulation of any such timetable would not be feasible at least until our earlier proposals have been implemented, and a more competitive environment has begun to develop.

authority to take such action only if Congress amends the Act. Accordingly, it would be advisable also to ask Congress now to amend Section 22(d) to give the Commission increased administrative discretion to deal flexibly with mutual fund pricing in the manner outlined below. 1/ Obviously, a

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1/ Such legislation would be somewhat analogous to the authority which S. 2519, the National Securities Market System Act of 1974, would provide the Commission to deal with problems relating to third market trading. Section 11A(m)(1) of that bill provides as follows:

> "If the Commission finds, after notice and opportunity for hearing and such consideration as it deems necessary or appropriate of conditions arising after the rules of national securities exchanges fixing rates of commission have been eliminated, that as a result of transactions in securities registered pursuant to section 12(b) of this title effected otherwise than on a national securities exchange the fairness or orderliness of the markets for such securities has been or is likely to be affected in a manner contrary to the public interest or the protection of investors, the Commission, in accordance with its powers under this title, shall prescribe such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors to restore or maintain the fairness and orderliness of the markets for such securities. In addition to its other powers under this title, the Commission is authorized, in prescribing rules and regulations under this subsection, to prohibit brokers and dealers from effecting transactions in such securities otherwise than on a national securities exchange, if it makes the findings herein above specified and further finds that no rule of any national securities exchange unreasonably impairs the ability of any dealer to solicit or effect transactions in such securities for his own account or unreasonably restricts competition among dealers in such securities or between dealers which are specialists in such securities and dealers which are not specialists in such securities. The Commission may conditionally or unconditionally exempt any security or transaction or any class of securities or transactions from any such prohibition if the Commission deems such exemption consistent with the public interest and the protection of investors."

Footnote Contd.

Footnote 1/ Contd.

In its report on the bill, the Senate Committee on Banking, Housing and Urban Affairs commented upon this provision as follows:

> "/T/he Committee realizes that it is impossible for anyone to predict with absolute certainty the results of instituting competitive commission rates in the securities industry. As the SEC stated to the Committee, '... the NYSE's serious reservations about the implications of these changes /makes it/ obvious that reasonable men can differ concerning such predictions.'
>
> "In light of the possibility that the fears expressed by the NYSE and others may be realized, the Committee believes that the SEC should be vested with flexible and effective power to deal with any serious disruptions in the operation of the markets for listed securities caused by trading in the third market. Section 11A(m) embodies this proposition and would serve two purposes: First, it would direct the SEC to take all steps within its existing powers and those provided by the bill to correct any adverse affect on the fairness or orderliness of the markets for listed securities caused by third market trading. Second, the provision would authorize the SEC, upon carefully prescribed factual findings, to confine trading in listed securities to national securities exchanges." S. Rep. No. 93-865, 93d Cong., 2d. Sess., 17 (1974).

precise determination of what actions should be taken in the future can only be based upon the facts appearing at that time, but the possibilities include the following:

1. Limited Retail Price Competition

a. At the Option of the Underwriter

At some point in the future, it might be appropriate to promulgate a rule exempting underwriters and contract dealers from Section 22(d) so as to permit mutual fund shares to be sold by such dealers at any desired sales load above the underwriter's spread, subject to a possible maximum set by the underwriter, provided the underwriter and the fund, at their option, provide for such price competition in the fund's prospectus.

Given the conclusion that there should ultimately be retail price competition in the sale of mutual fund shares, this could be an appropriate way to begin. 1/ Price competition would not be forced upon the industry; rather, underwriters and funds would be permitted to leave the shelter of retail price maintenance when they feel that the competitive environment is such that their dealer networks can function more efficiently without it. 2/ Under such an approach, to protect contract dealers from the price competition of a secondary market, the Commission might, pursuant to the expanded authority we suggest, prohibit fund shares from being traded in a secondary market. This would meet the problem of the difficulty contract dealers would obviously have in competing on the basis of price with secondary market-makers who would not have to include an underwriter's spread in the sales charges and could obtain shares from investors, to whom they would pay only a slight premium over net asset value.

1/ As a variation of this concept, it might be desirable to experiment with retail price competition starting with orders over a certain size and gradually expanding downward. Investment Company Act Release No. 7475 announcing the mutual fund distribution hearings posed this possibility by suggesting, as an alternative, the retention of retail price maintenance on smaller sales only, with negotiated rates and price competition prevailing on any portion of a purchase exceeding a fixed amount, such as those over $300,000. Subsequently, as feasible, the Commission could gradually reduce the size of purchases above which competition would be permitted. Of course, it would be necessary to maintain a flexible approach to this problem and adapt to the situation as it developed. For instance, price competition might turn out to be more disruptive on large orders than on small orders because large investors might have the market power to force sales loads to uneconomic levels.

2/ As investor sophistication generally increases and more customers find that they do not need the full range of services offered by mutual fund salesmen, they might begin to "shop for bargains," choosing to buy shares from a certain dealer, not because he offers a full range of selling services, but rather because he offers a lower price. Some dealers might find it profitable to "unbundle" their services, offering reduced sales charges to the investor who "does not want, does not need, and does not get" intensive selling service. Conversely, the customer who is not prepared to invest in funds unless he receives all of the selling service traditionally provided by mutual fund retailers could continue to receive such service, and he would pay the full sales load to cover its cost.

b. Required by Commission Rule

It is possible, even after the mutual fund distribution environment has become sufficiently competitive to make feasible a move to retail price competition, that the industry will not take advantage of the opportunities we recommend and will not provide for it in most cases. If this should occur, it then may be desirable and necessary for the Commission to require unfixed sales charges on the part of contract dealers with the same protection against a secondary market. It would be preferable, however, if retail price competition could be introduced on a voluntary basis, since this would permit each underwriter to determine when its particular distribution system is ready for such competition. 1/

2. Full Retail Price Competition, Including a Secondary Market

A broader form of price competition might be practical if the competitive environment for the distribution of mutual fund shares improves and the distribution of fund shares becomes less dependent upon intensive efforts by salesmen. If that point is reached, it should be feasible to eliminate retail price maintenance with respect to all mutual fund retailers; the secondary market would not be prohibited and contract as well as non-contract dealers would compete with each other. 2/

Even in a fully competitive environment, however, the nature of the mutual fund industry will demand that fund underwriters and contract dealers be protected from unfair competition on the part of secondary market-makers. That is, since mutual funds shares are continuously issued,

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1/ Even if the Commission received and exercised the authority to prohibit retail price maintenance in the sale of mutual fund shares, funds could still distribute their shares at a fixed price through "captive" sales organizations. This should not give a marketing advantage to funds with captive sales organizations, however, since the Commission would not require - or even permit - retail price competition until it became clear that the necessity for a sales "push" had been largely replaced by a demand "pull."

2/ Exercising the expanded statutory authority we recommend, the Commission might choose to permit underwriters and contract dealers to enter into voluntary price maintenance agreements, although such agreements would not prevent funds from being sold at different prices by non-contract dealers. However, even such limited, voluntary retail price maintenance might be unnecessary in a fully competitive environment, and it is questionable whether underwriters would desire to bind contract dealers to price maintenance agreements.

underwriters must bear continuing distribution costs; these costs would be present even if a competitive environment has largely eliminated the need to recruit and train a sales force, since an underwriter would still have to pay for such items as the preparation of prospectuses and advertising. Since an underwriter would receive no spread on shares sold in a secondary market, it would be necessary to provide underwriters with some substitute compensation. Similarly, since contract dealers do share a portion of the sales load with the underwriter, it would be unjust if competing secondary market-makers were not also required to bear certain costs to sustain the mutual fund distribution system and to bear certain burdens in order to assure, even in a price competitive environment, that they do not enjoy an unfair competitive advantage over contract dealers to the point of drying up fund distribution at the primary level. 1/

To accomplish this a fund might be permitted to impose a reasonable fee when ownership of its shares is transferred from a non-contract dealer to a customer. 2/ This would be designed to compensate the fund for the administrative costs of transferring ownership on its books, and some of it might be allocated to subsidize the sales effort to help offset the underwriter's general distribution costs. At the same time, such a fee would reduce a secondary market-maker's price advantage vis-a-vis a contract dealer. Also, in order to prevent secondary market makers from "dumping" their inventories of shares upon the fund by redeeming them when sales are slow, funds could prevent such market-makers from redeeming shares for a reasonable period of time after purchasing them, such as three months, or in more than limited amounts for stated periods. 3/ This would force secondary market-makers to absorb some risk from the funds during periods of slow sales and would thus help compensate for the fact that the fund's underwriter receives no spread on sales by non-contract dealers. And, again, the cost of bearing this risk would help narrow the gap between the minimum prices which contract and non-contract dealers can profitably charge.

1/ These considerations are similar to those which have underlain historic objections to a secondary market in mutual fund shares.

2/ Funds could impose such fees if the fees were provided for in the fund's registration statement, so long as the Commission does not adopt a rule prohibiting them pursuant to Section 22(f).

3/ Cf. Section 12(d)(1)(F) of the Act, which limits the free redeemability of fund shares held by a fund holding company.

SUMMARY -- Recommended Legislative Proposals for Additional Administrative Authority

The Division recommends that the Commission ask Congress to amend Section 22(d) to provide the Commission with increased administrative discretion to deal flexibly with mutual fund pricing in the future. The Commission's authority should be expanded sufficiently to enable it to take some or all of the following actions:

(1) Require mutual funds to institute price variations such as those described earlier in this memorandum;

(2) Permit or require limited price competition among contract dealers only; and

(3) Abolish retail price maintenance among both contract and non-contract dealers, subject to certain provisions designed to prevent a secondary dealer market from injuring funds and their distribution systems.

C. Recommended Regulatory Safeguards

In addition to determining what steps to take to foster competition in the distribution of fund shares, the Commission must also pass upon the NASD's proposed rule which would place ceilings on the sales loads which funds may charge. As indicated above, in 1966 the Commission had urged that Congress set a 5% maximum on fund sales loads. Instead of repealing Section 22(b) or imposing a maximum on fund sales loads, Congress amended Section 22(b) to give the NASD the authority, with Commission oversight, to promulgate rules which would prevent the price at which mutual fund shares are sold from being "excessive." Such sales loads must allow for "reasonable" compensation for sales personnel, broker-dealers and underwriters and for "reasonable" sales loads for investors.

In the 18-month interval between adoption of amended Section 22(d) and the point at which the Commission could have adopted its own rules to implement the section, Booz - Allen & Hamilton conducted a study for the NASD which provides a basis for its rule proposal. The portions of that study, "An Economic Study of Distribution of Mutual Funds and Variable Annuities" (Parts I, II, and III), dealing with mutual fund and variable annuity sales loads were submitted to the Commission in June 1972 along with the NASD's proposed maximum sales load rule.

1. The NASD's Proposed Sales Load Levels for Mutual Funds

As the NASD has described its Rule proposal, it would permit mutual funds to charge maximum sales loads of:

8.50% for purchases of up to $10,000 or $15,000;

7.75% for purchases between $10,000 and $25,000; or

7.50% for purchases between $15,000 and $25,000; and

6.00% 1/ for purchases of $25,000 and over.

1/ The NASD states that a fund offering neither dividend reinvestment at net asset value, rights of accumulation, nor quantity discounts would be limited to a 6% maximum sales charge. However, the proposed rule is ambiguous on this point, and can be read as permitting a 6.25% sales load on purchases of $25,000 even where none of the above features are offered. When this anomaly was called to the attention of the staff of the NASD, the Division was advised that it was an oversight and that the rule would be clarified to reflect 6.25% as the maximum permissible charge when all three features are lacking.

However, the right to charge that maximum would be contingent upon the fund offering:

(1) Dividend reinvestment at net asset value. If the fund elects to charge for dividend reinvestment, the maximum load it could charge would be reduced by 1.25 percentage points.

(2) Rights of accumulation. (The right to purchase additional shares at breakpoints when the cost or the value of an investor's holdings plus any additional purchases reach the breakpoint level.) If a fund should choose not to offer a right of accumulation, the maximum load would be reduced by .5 percentage points.

(3) Volume Discounts. The rule requires volume discounts at either the $10,000 or $15,000 purchase level and at the $25,000 purchase level. Failure to provide such discounts could reduce the otherwise allowable sales load by as much as .75 percentage points.

The 1.25%, .5% and .75% penalties are intended to correct the imperfections which the NASD perceived in the mutual fund pricing structure in order that it correspond more fully to a pricing structure which would exist under a system of effective competition. 1/

On November 3, 1972, the Commission advised the NASD that it would be desirable to publish the proposed rules for comment. The Commission also indicated it would hold hearings on its staff study of the Economic Impact of the Repeal of Section 22(d) and on related aspects of mutual fund distribution and that the comments the NASD received, and the testimony we would receive, would provide a public record on the basis of which the NASD and the Commission could discharge their respective responsibilities with respect to Section 22(b). 2/ The NASD, by letter of November 6, 1972 sent to All NASD Members and Interested Persons "Proposed Amendments to Regulations Governing Sales Charges on Mutual Fund Shares and Variable Annuity Contracts," and requested comments on the Rule proposals. The NASD has deferred further action pending recommendationsby the Commission.

1/ NASD Study, pt. I, p. II-4; Tr. 1937 and 1969-70.

2/ Letter of Chairman Casey to Gordon Macklin, President of the NASD, November 3, 1972.

The discussion below sets forth our conclusions and recommendations with respect to the NASD proposed rule package.

2. Impact of the NASD Rule Proposal

The NASD estimates that its proposed rule would reduce sales charge income of fund underwriters and distributors by 9 or 10 percent based upon 1970 non-contractual cash sales (including dividend reinvestments). 1/ This conclusion was based upon its analysis of the economic effects of the following alternative assumptions:

Alternative 1 - That no fund would alter the bundle of features and services it offered in 1970; but would instead incur the price reductions imposed by the rule. This would have resulted in an estimated reduction in sales charge income of about 9 percent.

Alternative 2 - That each fund would adopt those features and services listed in the rule rather than incur the price reductions imposed by the rule. This would have resulted in an estimated reduction of sales charge income of slightly more than 10 percent.

This approach does not make allowance for another alternative: the possibility that each underwriter will choose that mix of product features which would result in the least reduction of its income, or that underwriters of funds with sales loads now below the maximum level permitted under the rule would increase them to the maximum permissible levels. On that basis, under Alternative 1 we estimate that, based upon 1970 sales, the total reduction in industry sales revenues would not exceed 7%. The 10% reduction would fall unevenly on various fund underwriters. The NASD's consultants estimated that dividend reinvestment income could amount to as much as 25 % of the income of underwriters of funds which now charge a sales load on dividend reinvestments. For those which do not charge a sales load on dividend reinvestments, we estimate that the total reduction in income would be approximately 1% - under either Alternative 1 or 2. The 10% figure is subject to a number of additional variables. It would depend upon fund dividend yield rates and the ratio of dividend reinvestments to other

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1/ NASD, Estimated Effect NASD's Proposed Rule (As Approved By Board of Governors, May 9, 1972) on Sales Charges on Mutual Fund Shares, August, 1972. Transmitted to SEC, September 20, 1972.

sales. For example, mutual fund dividend yields were higher in 1970 than in any of the previous 10 years. Similarly, the ratio of dividends reinvested to total sales in 1970 was almost double the immediately preceding years' ratios, indicating that the 10% figure might be slightly higher.

The NASD explained that if all funds elected to provide full services under the rule, assuming sales remained at 1970 levels:

> 24% of the funds would have to reduce their maximum sales charges (a reduction of approximately 0.25 percentage points which would be about 3% of an 8.75% sales load);
>
> 22% of the funds would have to provide dividend reinvestment at net asset value; and
>
> 38% of funds would have to make rights of accumulation available.[1]

3. Our Recommendation

We do not recommend that the Commission oppose adoption of the NASD's proposed maximum sales load rule.

a. Policy Reasons

As a matter of policy, we do not believe it would be appropriate to impose tighter limits on sales loads than those proposed by the NASD at a time when the securities industry is entering a period of negotiated rates and while we are attempting to develop an improved competitive environment for mutual funds. As indicated above, conditions in the mutual fund industry have changed drastically since 1966 when the Commission found that mutual fund sales charges bore "no reasonable relationship to the cost of investing in other types of securities." 2/ Although the sales charges on fund shares are still greater than the cost of purchasing listed securities, especially at the $5,000 to $25,000 levels, today's problems relate less to costs than to the nature of the distribution system. We believe it more important in the long run to attempt to establish greater opportunities for competition than to impose a more restrictive regulatory pattern.

1/ Testimony of John C. Bogle, Chairman, Investment Companies Committee of NASD, Tr. 26.

2/ Mutual Fund Report, p. 221.

b. Practical Problems -- Lack of Meaningful Economic Data Base

As a practical matter, we find it impossible to arrive at any better sales load maximums to meet the standards of Section 22(b)(1) on the basis of existing data. We have examined in great detail the OER Study, the testimony presented at the hearings, and additional materials concerning appropriate maximum sales loads. We feel that the only reasonable conclusion that can be reached from this exhaustive study is to echo Investment Company Act Release No. 7635 concerning the development of an adequate economic data base in saying that: "Information currently available concerning the financial environment of mutual fund management companies is both incomplete and inconsistent...."1/ The inadequate data available simply do not provide clear and convincing evidence that any particular sales loads are optimal. As indicated above, Section 22(b)(1) requires that sales loads shall allow for reasonable compensation for sales personnel, broker-dealers and underwriters and for reasonable sales loads to investors.2/ Under this standard, a sales load reasonable to investors from the standpoint of the value of the service they receive might be so low that it would offer inadequate compensation to sales personnel, broker-dealers and underwriters for their time and effort. On the other hand, a sales load which offers reasonable compensation to fund sellers might be so high that it would not provide reasonable sales loads to investors.

1/ Investment Company Act Release No. 7635, January 18, 1973, p. 2 (Appendix C).

2/ The Senate Committee Report indicated that the "reasonable compensation" requirement was intended:

> "To assure that fair consideration is given to the interests of both sellers and investors . . . This does not mean that such rules must preserve the current level of profitability of every salesman, broker-dealer, or underwriter in the business, irrespective of efficiency. It does mean, however, that consideration must be given to the nature and quantity of services necessary to effect the proper distribution of fund shares to the public." (Investment Company Amendments Act of 1969, Report of the Committee on Banking and Currency United States Senate to Accompany S. 2224, Report No. 91-184) (91st Cong., 1st Sess., May 21, 1969).

The House version of the bill (H.R. 14737, 91st Cong., 1st Sess.) had provided that any rules should allow "reasonable opportunity for profit for broker-dealers and underwriters." The bill as enacted adopted the Senate version, "reasonable compensation." (Investment Company Amendments Act of 1970, Conference Report to Accompany S. 2224, Report No. 91-1631) (91st Cong., 2d Sess., Nov. 25, 1970).

Either way, one should know the costs of the services furnished by the salesman and received by the investor. Both the Commission and the NASD have recognized the need for reliable cost data. In the announcement of Hearings on Mutual Fund Distribution, 1/ the Commission recognized that "if mutual fund sales charges are to be regulated, reliable data as to the industry's costs, profitability and general economic structure is necessary". It later released a Discussion of Development of An Adequate Economic Data Base 2/ which cited some of the data sources currently available for the purpose of monitoring economic trends and their limitations. Various methods of cost allocation and reporting formats were discussed. Subsequently, the NASD concurred "in the need to develop a comprehensive data base that will enable us to exercise continuing surveillance in a timely manner." It stated that after new rules have become effective it intended to initiate a data collection system,3/ but it also indicated concern that the development of a uniform system of accounts would entail a heavy financial burden on the industry unwarranted by the quality of the results. 4/

c. Benefits of the NASD Rule

Rather than pursuing a regulatory approach further, we recommend that the Commission accept the NASD rule as what we hope will be an interim measure which adds some rationality to the sales load structure by requiring those funds which charge the most to provide the full range of ancillary services. In so doing, the rule appears to correct one of the more flagrant deficiencies of the present sales load structure, which the Commission criticized in its Mutual Fund Report, the charging of a sales load on reinvested dividends. Under the rule, funds which do not offer dividend reinvestment at net asset value may not charge a sales load in excess of 7.25%.

Another possibility, and one perhaps worthy of serious consideration at some time in the future, would be to dispense with prescribed maximum sales loads altogether. In other words, the Commission might tell the NASD to adopt a rule prohibiting "excessive" sales loads, without translating that term into numbers. Such an undefined ceiling might be appropriate when increased price sensitivity among the public, coupled with improved disclosure of the effect of all charges upon total return, render investors more able to recognize -- and thus protect themselves against -- unreasonably high sales charges. Certainly for the present, however, the Division believes that excessive sales charges can be prevented only by stating a definite ceiling on such charges.

1/ Investment Company Act Release No. 7475 (Nov. 3, 1972), p. 9.

2/ Investment Company Act Release No. 7635 (Jan. 18, 1973).

3/ Statement of the NASD to the SEC (Feb. 2, 1973), pp. 66-69.

4/ Ibid.

d. Recommended Modifications of the NASD Rule Proposal

There are certain respects in which the Division believes the proposed rule should be modified:

(i) Exchange Privilege

We believe that the rule should require a reduction if a fund fails to offer an exchange privilege. The NASD Study noted that the exchange privilege is one of the most valuable product features offered by mutual funds. 1/ Nevertheless, it did not include a penalty provision in its rule to encourage exchanges at net asset value because of the burden it assumed such a penalty would place on single fund underwriters -- who account for about 10% of total industry assets. 2/ However, single fund underwriters might be able to avoid penalties by arranging exchange privileges with another complex if they wish to do so. Although exchanges at net asset value involving funds from different complexes are permissible under Section 11(a) of the Act, funds have not engaged in such practices (except pursuant to agreed upon mergers and reorganizations) because it would smack of stealing another fund's shareholders. In any event, the fact remains that the privilege can be valuable. As a service provided by many funds, under the NASD standard its presence or absence should be reflected in the sales load.

The argument for making the exchange privilege part of the rule was put by Mr. Bogle, speaking on behalf of Wellington Management Co. rather than the NASD. He pointed out that:

> "The exchange privilege is such a significant part of the competitive framework of this business, and such a significant benefit to investors, people should either be allowed to derive it more or less uniformly in the industry, or not allowed to do it." 3/

1/ NASD Study, p. III-32.

2/ Ibid.

3/ Tr. 1906.

The Division agrees. The exchange privilege provides additional protection and flexibility in rapidly changing markets. Funds which do not offer an exchange privilege are less attractive and less valuable. Therefore, applying the NASD's value of service standard, such funds should not charge the same sales load as funds that do offer an exchange privilege.

(ii) Sales Charges on Cash Management Funds

We further recommend that the NASD's proposed rule be modified in one other respect: the maximum sales load permitted on the sale of shares in cash management funds. The cash management fund concept emerged relatively recently as a probable response to an environment of high short-term interest rates and anemic stock market performance. The portfolios of these funds consist primarily of short-term U.S. government obligations, bankers' acceptances, certificates of deposit and commercial paper. They enable the small investor to benefit from high interest rates in the short-term money market which would otherwise be unavailable to him.

Although a relatively new phenomenon, cash management funds already account for a significant portion of industry sales and a growing portion of industry assets. 1/ But for the rapid growth of these funds, the industry as a whole would be in a net redemption position. 2/ Fifteen of the twenty funds with effective registration statements as of September 30, 1974 were no-load. We are concerned with the remaining 5 funds since they impose sales loads ranging from 1% to 8-3/4%.

1/ As of September 30, 1974, twenty cash management funds were offering shares to the public and nine more were in registration at that date. During the six month period from April through September, 1974, net sales per month of the nine cash management funds which were members of the ICI rose from $29 million to $242 million and their net assets climed from $61 to $867 million, an amount equal to almost 3% of the $32 billion total assets for funds which are members of the ICI. (Investment Company Institute Release, May through October, 1974). The net sales and assets of the other eleven cash management funds were also substantial. Reserve Fund, the largest non-ICI member cash management fund, alone reported net sales of $27 million and net assets of $369 million at September 30. Thus cash management funds now account for well over one billion dollars in industry assets.

2/ During the five month period May through September, 1974, all ICI member funds other than cash management funds reported monthly net redemptions ranging from $20 to $101 million.

The Anchor Reserve Fund charges an 8-3/4% sales load on the first $10,000 invested (minimum initial purchase $100), the Kemper Income and Capital Preservation Fund, Inc., charges a 6% sales load on the first $25,000 invested (minimum initial purchase $100), and Oppenheimer Monetary Bridge, Inc., charges 4-1/4% on the first $25,000 invested (minimum initial purchase $1,000). 1/ These sales loads, one of which even exceeds the permissible level under the NASD's proposed maximum sales charge rule for a traditional fund, appear to be excessive when applied to the purchase of cash management fund shares which are generally held out to be short-term investment vehicles. 2/

It would seem that sales charges on such investments should be consistent with their short-term horizon. Unlike longer-term investments sales charges on such an investment cannot be amortized over a period of years as charges of traditional funds can. For an investor to "park" his money for 3 months with a fund which charges a sales load of 8-3/4% and merely break even, the fund must have an annualized yield of about 35% net of management expenses. Even assuming current returns of 10% per annum continue, a shareholder of Anchor Reserve would be "locked-in" to this investment for over 10 months before such returns offset expenses. By similar calculations, for an investor in a fund which charges a 4-1/4% sales load to break even after 3 months, the fund must produce an annualized net yield of about 17%; assuming a yield of 10%, this investor would be "locked-in" to his investment for over 5 months in order to break even. 3/

1/ Fidelity Daily Income Trust, although no-load, charges a monthly $2.50 "account service fee". On a $5,000 investment this amounts to .6 of 1% per annum. In addition, this Fund states in its prospectus that if shares are purchased through a broker, he may charge a commission.

2/ New York Times, June 20, 1974, p. 57, and Wall Street Journal, April 16, 1974, p. 46. The fact that these funds are short-term vehicles is also evidenced by their high ratio of redemptions to net assets. During the six months from April through September, 1974, ICI member funds reported redemption ratios ranging between 10% and 11% on an annualized basis. However, during the same period, the cash management funds which were members of the ICI reported a redemption ratio ten times larger. Investment Company Institute Releases, May through October, 1974.

3/ The only justification claimed for these sales charges is that shares of the cash management fund can be exchanged for shares of an equity fund within the same complex when short-term rates drop or when the stock market becomes more appealing. See N.Y. Times, June 20, 1974, p. 58. This may be true, but it ignores the heavy front-end feature of such a sales charge. It is hard to rationalize a sales load, equal to the ordinary fund sales load, simply on speculation that the investor will, in the future if he desires, thereby be able to exercise his exchange privilege and switch at no-load into the more traditional fund.

When the NASD proposed its 8-1/2% maximum sales load rule, the cash management fund concept was in its infancy. However, the recent development of selling such funds at a load suggests that the NASD should modify its proposed rule to set different and presumably significantly lower maximum sales loads for the purchase of cash management fund shares, taking into account the short-term nature of investment in such funds.

e. Contractual Plans

Single payment contractual plans would be subject to the same 8.5% maximum charge as mutual funds. However, the NASD deferred formulating rules for periodic payment contractual plans until sufficient time had elapsed to permit a better assessment of the impact of the 1970 Amendments to Section 27 of the Act on the contractual plan industry. 1/ Since many contractual plan sponsors have deemphasized the sale of front-end load plans or switched to spread load plans, we concur with the NASD's recommendation. Sufficient data should be available in June of 1975 to permit a reexamination of the NASD Rule and our reserve requirements under Rule 27d-1. The Division intends to do so at that time.

f. Variable Annuities

The NASD proposal also provided the following maximum sales load for variable annuities:

i. Single Payment

8.5% of the first $25,000
7.5% of the next $25,000; and
6.5% of any payments over $50,000.

ii. Multiple Payment

Sales charges are restricted to 8.5% of the total payments as of a date not later than the end of the 12th year after the purchase.

1/ This would permit sales charges on such periodic payment plans to remain at their present levels which tend to cluster above 8.8% (assuming full payments are made over the life of a plan). The 1970 amendments to Section 27(d) and (e) of the Act provide for a refund only on those sales charges in excess of 15% and only for persons who redeem during the first 18 months after starting a plan.

We recommend a comprehensive approach to variable annuity charges based upon the total of administrative, investment management and insurance charges and sales loads. In the interim, we conclude that the NASD rule should be accepted as providing a modicum of protection for investors. However, we do not recommend that the Commission adopt a comparable SECO rule. 1/ A comprehensive approach to variable annuity charges is needed because a sales charge greater than that disclosed can be imposed either by characterizing it as an administrative charge; building it into the charges against assets of the separate account; or using an annuity table which is less favorable to the contractholder than is dictated by conservative mortality estimates. Since the economic effect of these other charges is generally much greater than that of the sales charge, and because it is difficult to separate out the various charges accurately, we believe the only effective way to evaluate variable annuity sales charges is on a comprehensive basis. 2/

As a first step in this effort, the Commission has already published for comment a proposed amendment to the Statement of Policy that would permit variable annuities to disclose the combined economic effect of all charges based upon hypothetical investment experience, i.e., illustrations, in sales literature and prospectuses. 3/ If such disclosure were required, the various regulatory authorities (the Commission, the NASD and State Insurance Administrators) and the investing public could better understand and compare various plans and overall charges. After we have had an opportunity to analyze such charges, we will be in a position to determine what ceilings, if any, would be appropriate and how they ought to be applied.

1/ The only variable annuity company which would be affected in any significant way by maximum sales load restrictions similar to those proposed in the NASD Rule for variable annuities is Aetna Variable Life Insurance Company, a SECO registered broker-dealer and not a member of the NASD. One of Aetna's contracts has an average sales load of 8.79% over a 12 year period. If the period was increased to 13 years, the average sales load on this contract would drop below 8.5%. Since changing this contract would require approval by all of the states, we question whether the benefits to the contract holders outweigh the costs of making this change.

2/ In addition to the Commission's authority under Section 22(b)(1) to prevent excessive sales loads, Section 26(a)(2) of the Act permits the Commission to prescribe reasonable fees for trustees or custodians of unit investment trusts "as compensation for performing bookkeeping and other administrative services."

3/ Securities Act Release No. 5516 (July 30, 1974). The NASD Study also indicated the need for a comprehensive approach. It noted that "regulation of sales charges could become a 'sieve' unless adequate surveillance also was maintained to guard against the possibility of attempts to evade the rule by shifting a portion of the Sales Charge to the Administration Charge." (NASD Study, Vol. I, p. III-94.)

g. Continuous Discounts

One of the questions raised in the announcement of hearings was whether Rule 22d-1 should "be amended to require that volume discounts be provided only where continuous schedules are in effect under which reductions fall only on that portion of the order in excess of the breakpoints?" 1/ Under existing sales load structures, purchasers of large volumes of mutual fund shares receive a volume discount when purchases are made in amounts exceeding specified breakpoints, e.g., $10,000, $25,000 or $50,000. The reduced charge applies to the entire purchase, not merely to the portion in excess of the breakpoint. This means that, for a fund with a basic sales charge of 8.5% which drops to 7.5% on purchases in excess of $10,000 or more, a $9,900 purchase will produce gross revenue of $841.50 for the selling organization. If the purchase were $100 greater, i.e., $10,000, total selling compensation would drop to $750. The announcement of hearings expressed the Commission's concern that such a system tends to discourage sellers from alerting prospects to the economies produced by breakpoints and places ethical strains on dealers and sellers. 2/

The NASD recognized the Commission's concern but was of the view that the problem was not of sufficient magnitude to warrant amendment of Rule 22d-1. It concluded "that the practical drawbacks of a shift to such a structure outweigh the advantage of avoiding the hitherto insignificant number of abuses of sales slightly below the breakpoints induced by salesmen's self-interested advice." 3/

The "practical drawbacks" objection refers to the way in which the fund business is conducted, particularly the manner in which shareholder accounts are kept. To introduce a continuous discount would require those funds which offer rights of accumulation to keep a running record of the amounts paid by investors rather than the number of shares held -- a figure from which the value of a shareholder's account may be computed. 4/ Funds selling through independent dealers would find it difficult to reconstruct what an investor paid in the first instance. Considering the fact that fund shares may be transferred in street

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1/ Investment Company Act Rel. No. 7475 (November 3, 1972).

2/ Ibid.

3/ Statement of the NASD to the SEC concerning Mutual Fund Distribution and the Potential Impact of the Repeal of Section 22(d) of the Investment Company Act of 1940, February 2, 1973.

4/ The right of accumulation might be based upon the value of a shareholder's account rather than cost to the shareholder.

name,this may be particularly difficult. "All the technological ability in the world will not tell you the answer to a question that is not in the computer," Mr. Bogle explained. 1/ "If you want to give him a price on the next investment you have to know what he bought." 2/

The practical problems with the implementation of a continuous discount requirement compel the conclusion that it should not be adopted at this time.

h. Dealer Discounts -- Regulation Not Recommended.

One of the issues posed in Investment Company Act Release 7475 was whether the size of the dealer discount should be regulated. 3/ The release posed the questions whether:

(1) Varying dealer discounts might unduly influence dealers' recommendations of the funds, and

(2) Present practices contribute to pressure to raise sales loads or reduce distributors' margins.

The NASD has declined to regulate the dealer discount separately from the sales load, largely on the ground that such regulation would unduly interfere with the distribution process.

On the other hand, there is much to recommend direct regulation of the dealer discount. Many of the steps which are regarded as necessary to develop a competitive environment, such as increased advertising and expanded group sales, will require vigorous efforts on the part of the underwriters. The typical underwriter's spread has already been seriously eroded, and it might well be argued that, if some action is not taken to assure underwriters a profit, they will simply not have the wherewithal to undertake the new marketing strategies needed. 4/

1/ Tr. 1952.

2/ Tr. 1953.

3/ P. 6. It was suggested that the Commission could deal with this matter "by classifying as an 'underwriter' under Section 2(a)(40) of the Act anyone who receives more than the 'usual and customary distributor's or seller's commission' on the sale of mutual fund shares." In the alternative the release asked whether the NASD or the Commission should limit dealer discounts pursuant to Section 22(b).

4/ The pressure upon underwriters to surrender ever-increasing portions of their profits to dealers is illustrated by those instances where dealers have been offered the entire sales load for certain periods of time. See pp. 31-33, *supra*.

Nevertheless, the Division does not recommend that the Commission regulate the dealer discount. Although such regulation would tend to insulate underwriters from pressure to share more of their revenues with retailers, it would also tend to remove what would otherwise be an incentive to experiment with new marketing techniques. The discomfort which underwriters can experience from dealers demanding ever larger discounts may encourage them to experiment with alternative marketing strategies which rely less upon the dealers' selling "push". Such experimentation and innovation is essential if the industry is to move toward the goal of retail price competition.

SUMMARY -- Regulatory Safeguards

Although the Division recognizes certain shortcomings in the NASD's proposed maximum sales load rule, we do not believe that a significantly better approach to the regulation of sales charges could be developed at this time, given the limitations of available cost data. Accordingly, the Division recommends that the Commission not oppose adoption of the proposed rule by the NASD, subject to certain limited modifications, since it does add some rationality to the mutual fund sales load structure.

APPENDICES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

Honorable John Sparkman
Chairman of the Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to transmit for your committee's consideration our staff's study of the potential economic impact of the repeal of section 22(d) of the Investment Company Act of 1940. That section permits mutual fund managers to fix the prices at which fund shares are sold to the public and requires that all retail dealers adhere rigidly to such prices.

The wisdom of this 32-year old resale price maintenance provision has been hotly debated. Many think that it simply raises investors' costs without conferring any compensating benefits on them or on the public interest. Others maintain that resale price maintenance is so basic to the mutual fund distribution process that its removal would have a devastating impact on the investment company industry, the capital markets, and perhaps on the economy as a whole. This controversy figured prominently in the debates on investment company reform engendered by the Commission's 1966 report on the Public Policy Implications of Investment Company Growth[1] and by the earlier studies on which that report built.[2] When your committee addressed itself to this thorny subject and considered deleting section 22(d) from the Investment Company

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[1] House Report No. 2337, 89th Cong., 2d Sess. (1966).

[2] Those studies were the so-called "Wharton Report" (Wharton School of Finance and Commerce, A Study of Mutual Funds, House Report No. 2274, 87th Cong., 2d Sess. (1962)) and the Commission's Special Study of the Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess. (1963).

Act, it concluded that the consequences of this step had been insufficiently studied. Accordingly, your committee asked the Commission to review the subject and to submit a report with respect to it.[3/] Responding to that request, the Commission directed its Office of Policy Research to make this study.

This document is a report to the Commission from its staff. It is an analytical study that makes no recommendations for legislative or administrative action. But my colleagues and I believe that the data here assembled and the analyses here presented can contribute substantially to rational policymaking in this important field.

There are inherent limitations in any attempt to predict the economic consequences of legislative action. Those limitations are especially marked when, as is here the case, one attempts to assess the impact of retail price competition on a segment of the economy where it has traditionally been suppressed. It must also be remembered that the investment company industry is dynamic; its public acceptance is continually influenced by basic socio-economic forces such as changes in the economy and markets, availability and awareness of alternative products and general investors attitudes as well as by the intricate regulatory framework within which it operates. Hence precise assessment of the consequences of a legislative or an administrative change may well be difficult even after the change has been made--let alone before. For example, it has often been asserted that the abolition of retail price maintenance in this field would lead to a marked diminution of selling incentives, causing the sale of new fund shares to fall below the level of redemptions. Thus fixed prices for mutual fund shares have been viewed as a safeguard against net redemptions. Yet recent experience shows that net redemptions can coexist with retail price maintenance and that the level of sales compensation is but one of a number of factors affecting the popularity of mutual fund investment.

Certainties being hard to come by, we must assess probabilities as carefully and as intelligently as we can.

3/ S. Rep. No. 91-184 to accompany S. 2224, at p. 8.

That this report, based as it is on a survey of pertinent economic data, does. Its salient conclusions are these:

(1) Impact on investors

(a) The repeal of section 22(d) would result in lower acquisition costs for many mutual fund investors.

(b) But it is highly unlikely that the very small investor (one who puts a thousand dollars or less into a fund distributed by dealers and salesmen) would reap any immediate benefit.

(c) The above conclusions relate to funds distributed by independent dealers. Not all funds fall into this category. Some, among them two of the largest in the industry, are sold through so-called captive sales forces. These captive organizations are the sole distributors of the funds they sell. Because each such fund is sold by only one organization, there is no scope for direct price competition in this substantial segment of the industry. Moreover, buyers of captive-distributed funds are often unaware of alternative investment opportunities. This means that the repeal of section 22(d) will, in itself, do little, if anything, to lower these investors' acquisition costs. But other measures leading to wider public awareness of mutual funds and of what they offer (thus reducing the need for intense personalized sales effort) might eventually have a significant impact here.

(2) Impact on mutual fund sales organizations

(a) Captive sales organizations

As has already been pointed out, the nature of their distribution system and of the market that they serve would insulate captive sales organizations from the impact of retail price competition among independent retail dealers in mutual fund shares.

(b) No-load funds

The shares of these funds are sold at net asset value without the addition of any sales charge. Lower

distribution costs elsewhere in the industry would have no appreciable effect on its no-load sector.

(c) Independent broker-dealers

The impact of the cost-saving that investors would realize from the repeal of section 22(d) would fall almost entirely on the independent broker-dealers who made three-fourths of all load fund sales in 1970 and who during that year derived gross revenues of $150 million from this source.

(d) Gravity of impact on independent broker-dealers

Although the great bulk of the sales charges that mutual fund purchasers pay goes to independent broker-dealers, these charges are not a significant revenue item for most brokerage firms or for the securities industry as a whole. When one looks at the total income of all brokerage firms that sell mutual fund shares, one finds that revenue from this source accounted for 7.6% of 1969 aggregate gross revenue and for only 5.3% of 1970 aggregate gross revenue. And the New York Stock Exchange member firms that sell mutual fund shares derived only 3% of their total gross revenue from this source in 1969 and a mere 2% in 1970. Looking at the securities industry as a whole, i.e., at firms that do not sell mutual fund shares as well as at those that do, mutual fund sales accounted for only 5.8% of 1969 gross revenue and for 3.8% of 1970 gross revenue. These figures show that the reductions in mutual fund sales charges that would probably result from the repeal of section 22(d) would have an extremely modest impact on the securities industry and on most retail sellers of mutual fund shares.

There is, however, a group of broker-dealer firms whose business consists almost entirely of selling mutual fund shares. Any significant change in prevailing levels of mutual fund sales compensation would, of course, have a serious impact on these firms. That impact would fall most heavily on the firms that obtained more than 90% of their 1970 gross revenue from selling mutual fund shares. They represent about 13% of the broker-dealer community. It should be noted that the mutual fund industry is far more important to these firms

than they are to it. Only about one-fifth of the independent broker-dealer community's 1970 mutual fund sales revenue went to them. And even these firms are not nearly so dependent on mutual fund sales as they at first blush appear to be. Many of them are parts of larger sales organizations which sell such non-equity financial products as life insurance and real estate in addition to securities, primarily mutual funds. The financial data with which our staff worked relates only to these firms' securities activities, which in many cases is only a small part of the firm's overall business.

(3) Impact on salesmen

For most full-time securities industry salesmen section 22(d) is of little moment. Most salesmen who sell securities on a full-time basis receive less than 10% of their total income from mutual fund sales. The salesman who concentrates on selling funds tends to be a part-timer. And whether full-time or part-time, his income today under price maintenance is much lower than that of other professionals in the securities business.

(4) Impact on the investment company industry

(a) Improbability of extended net redemptions

The repeal of section 22(d) is unlikely to lead to protracted net redemptions on an industry-wide basis. Any lessening of sellers' incentives would be offset to some extent at least by the diminished sales resistance normally associated with lower prices. Pertinent in this connection is the marked recent growth of the industry's no-load sector. A competitive regime would permit group sales on a low-load basis. It would also tend to reduce the extent of the sales charges that many funds now impose when existing shareholders reinvest their dividends--transactions involving no fresh sales effort. The available evidence shows that when shareholders are permitted to reinvest dividends free of charge, they are more likely to make such reinvestments.

(b) The possible development of a secondary market

Under the existing statutory scheme, load mutual funds are distributed through fund underwriters which

are either captive sales organizations or independent dealers. Repeal of section 22(d), it is sometimes suggested, will lead to the development of a secondary market which would end-run existing distribution procedures. It is not at all clear that this would happen. To the extent such a market may develop concern over adverse consequences which might result seems exaggerated.

(5) Impact on the capital markets and on the economy

Reductions in mutual fund selling compensation would have no significant impact on the stock market or on the economy. Mutual funds figure prominently in the marketplace. But they are more significant as traders switching from one security to another than they are as net investors. The funds' trading activities add liquidity and depth to the market. But a free price system for mutual fund shares will not detract from their ability to do this.

As previously noted, this staff report makes no express recommendations. But its findings certainly suggest there is no compelling public interest in continued retail price maintenance in this field and that the repeal of section 22(d) would on balance be desirable. Whether that step should or should not be taken is, of course, for the Congress to decide. This Commission, however, as the agency charged with administering the Investment Company Act, protecting investors under that and other statutes and safeguarding the public interest in the investment process is under a duty to give the Congress the benefit of its own judgment. That responsibility we intend to discharge.

Before making any definitive recommendations to the Congress as to what should or should not be done about section 22(d), the Commission will hold public hearings at which interested persons will be asked to direct our attention to aspects of the mutual fund sales compensation problem that the report may have overlooked or to which it may have given insufficient weight.

The Commission wishes to hear from all segments of the investment company and the securities industries, from the economic profession, from the Department of Justice, and from anyone else who appears capable of enlightening us before we make a judgment of our own on the basis of an adequate record, including this report. The hearings that we propose to hold

will focus in large measure on the pros and cons of section 22(d). But they will not be confined to that topic. They will go into the whole mutual fund sales picture and will help us to develop a program that will enable investment companies to bring their message to the investing public more effectively and more economically than they are now doing. In addition to a re-examination of section 22(d), this entails a re-examination by this Commission of some traditional administrative positions that may have outlived their usefulness.

Among the areas calling for review on our part, a review in which the forthcoming hearings will assist us, are these:

A. Advertising--Advertising, an effective and a relatively low-cost method of conveying information to prospective purchasers, has been confined to a minimal role in the marketing of investment company securities. Rigid restrictions on advertising have been deemed compelled by the Securities Act's prospectus provisions, which apply to all issues of new securities. For most issuers, however, those restrictions are temporary and sporadic. They seldom issue new securities. And when they do, the duration of the offering period--and therefore of the Securities Act's restrictions--is short. But the overwhelming majority of mutual funds are continuously offering their own new shares to the public for cash. Hence they are always subject to the restraints that the Securities Act imposes on advertising. Those restraints have made it extremely difficult for the mutual fund industry to make much of an educational effort by means of the printed word and the mass media. The industry operates in an environment in which time-consuming face-to-face contact between a salesman and a more or less uninformed prospect is crucial. This makes for high selling costs. We recently liberalized our rules with respect to the advertising of investment company securities. But appreciable further liberalization would seem to be in order.

B. Simplifying mutual fund prospectuses and making them more readable--The advertising restrictions to which I have just referred rest on the premise that the statutory prospectus will be the key selling document. At present that premise is highly unrealistic. Selling practices typically relegate the prospectus to a backseat, secondary role and, very often the legal requirements result more in confusing the ordinary investor than assisting him in reaching an informed judgment. We must pare our mutual fund prospectus requirements down to

essentials and develop an administrative program that will elicit simple, clear prospectuses geared to the ordinary mutual fund investor's needs.

C. Group Sales--Mutual fund sales charge schedules provide for quantity discounts on larger orders. But the Commission's rules under section 22(d) preclude the grouping or pooling of orders for the purpose of obtaining such discounts. There is a serious question as to whether this anti-grouping rule, which superseded contrary administrative positions, has outlived its usefulness.

D. Reducing Paperwork in Small Transactions--Payroll deduction plans and other voluntary plans for accumulating mutual fund shares by means of periodic small purchases have a great area of potential usefulness. Unfortunately, however, some of the present rules under the federal securities laws make such plans more expensive than they need be. The rules in question require that each fund shareholder receive such individual notices and services as individual confirmations, dividend statements, and shareholder reports. We propose to examine whether altering these rules to make for lower costs on small transactions would diminish the basic investor protections they provide.

E. Volume Discounts--The discounts given volume purchasers of mutual fund shares must be re-examined. When such levels as $10,000, $25,000, $50,000 are reached, the sales charge drops. At present the reduced charge applies to the entire purchase and not merely to the portion in excess of the so-called break-point. This makes for strange results. Take, for example, the quite common case of a fund with a basic sales charge of 8.5%[4], which drops to 7.5% on purchases of $10,000 or more.[5] In this situation a $9,900 purchase will produce gross revenue of $841.50 for the selling organization. If the purchase goes up just another hundred dollars to $10,000, total selling compensation drops rather sharply to $750. And even on an $11,000 purchase, total sales revenue comes to $825, which is still less than

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4/ Actually, 9.3% when viewed as a percentage of the net amount invested rather than as a percentage of the total offering price.

5/ Actually, 8.1% when computed on the basis described in the preceding footnote.

the $841.50 produced by a $9,900 purchase. Such a system discourages sellers from alerting prospects to the economies produced by the breakpoints. The status quo thus places unnecessary ethical strains on dealers and salesmen. We must consider replacing it with schedules that fall only on the portion of the order in excess of the breakpoint.

F. No-Load Sales--Under present administrative interpretations brokers and dealers have no direct incentive to recommend so-called "no-load" funds, i.e., funds that sell their shares directly to the public free from any sales charge. Since these funds' prospectuses state that there is no sales charge, the imposition of any charge for recommending the shares or for effecting the purchase has been viewed as an impermissible deviation from the prospectus. Consideration will be given to the desirability of altering this position so as to permit brokers and dealers to charge a normal stock exchange commission for recommending and effecting an investment in a no-load fund.

G. Rules with Respect to Excessive Sales Loads--So long as section 22(d) remains in effect, legal controls on sales charges are necessary so as to compensate for the absence of normal competitive restraints. And even if that section should be repealed, there might well continue to be a strong case for legal controls to protect the unsophisticated mutual fund investor against excessive charges. The 1970 amendments to sections 22(b) and 22(c) of the Investment Company Act authorize the National Association of Securities Dealers, Inc. ("NASD") and the Commission to prescribe rules aimed at assuring investors of reasonable sales loads but allowing for reasonable compensation to sales personnel, broker-dealers, and underwriters. The NASD has developed rule proposals on this subject and will shortly publish those proposals for comment by its membership. We expect the hearings to assist the Association and the Commission in evaluating their proposals in order to strike the fair balance between the interests of mutual fund buyers and those of mutual fund sellers that the Congress has directed us to seek.

H. Development of an Adequate Economic Data Base--If mutual fund sales charges are to be regulated, the regulators must be well supplied with reliable data as to the industry's

costs, profitability, and general economic structure. Such data must be available on a continuous basis so as to enable the regulators to monitor trends, thus avoiding the undue regulatory lag that has plagued other types of regulation.

By direction of the Commission:

William J. Casey
Chairman

FOR RELEASE November 3, 1972

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Investment Company Act of 1940
Release No. 7475
Securities Exchange Act of 1934
Release No. 9848

ANNOUNCEMENT OF HEARINGS ON MUTUAL FUND DISTRIBUTION AND THE POTENTIAL IMPACT OF THE REPEAL OF SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940

The Securities and Exchange Commission, having reviewed the Study of the Potential Economic Impact of the Repeal of Section 22(d) conducted by its Office of Policy Research and the Economic Study of the Distribution of Mutual Funds and Variable Annuities conducted for the National Association of Securities Dealers, Inc. ("NASD") by Booz Allen & Hamilton, Inc. has determined that it would be appropriate to re-examine traditional administrative positions and to explore new possibilities in order that mutual funds may be marketed more efficiently at a reasonable cost to investors. Section 22(d) requires, in part, that in the sale of a mutual fund security to the public the principal underwriter and any dealer must sell the security at a current public offering price -- net asset value plus stated sales charge - set forth in the prospectus.

In order to obtain a wide range of viewpoints with respect to the justification for this retail price maintenance provision in the distribution of mutual funds, as well as the options which would be open to the industry if Section 22(d) were eliminated and how the industry would adjust to such a change, the Commission has determined to commence public hearings on December 11, 1972.

Background

A. Study of the Potential Economic Impact of the Repeal of Section 22(d) of the Act.

In the Investment Company Amendments Act of 1970 (the "1970 Act") Congress took steps to improve the protection afforded mutual fund investors in the area of sales commissions. The Senate Committee on Banking, Housing and Urban Affairs indicated that "Partly because of Section 22(d) and partly because of the way in which mutual fund shares are sold, competition has tended to operate in reverse in the sale of mutual fund shares -- raising

prices rather than lowering them". 1/ The Committee gave serious consideration to deleting Section 22(d) from the Investment Company Act of 1940 (the "Act"). However, it was uncertain what that would mean to the investing public and mutual fund sales organizations. Therefore, it requested that the Commission review the consequences of such a proposal and report to it as soon as reasonably practicable.

Our staff is about to complete this study which will be released shortly. It deals among other things with the costs of distributing mutual funds, the earnings of those who sell mutual funds, the significance of revenue derived by brokerage firms from mutual fund sales and the significance of mutual fund sales to the securities markets. Before making any definitive recommendations to the Congress as to retail price maintenance the Commission believes it imperative to have the views of all interested persons with respect to the staff's report and the impact on the industry of various changes in the distribution system that may be desirable.

B. NASD Study and Rule Proposals

The 1970 Act gave the NASD rule-making authority to prevent mutual funds from being sold at a sales load which is "excessive". Under amended Section 22(b) of the Act mutual fund sales charges must allow for reasonable compensation for sales personnel, broker-dealers and underwriters, and reasonable sales loads to investors. The amendments also provide the Commission with the power to alter or supplement such NASD rules at any time after June 14, 1972 -- the effective date of this amendment. It was contemplated that during this period the NASD would study "all relevant factors" in order to provide a basis for its rule proposals. At the outset the Commission made clear that the NASD study should consider ways in which the existing distribution system could be improved with the resulting efficiencies and lower costs passed on directly to benefit investors and that the Commission would consider the feasibility of achieving this result in connection with its staff study of the impact of eliminating Section 22(d) from the Act.

1/ S. Rep. 91-184, 91st Cong. 1st Sess. 8 (May 21, 1969).

The NASD has now completed its study and has drafted rule proposals based upon it. That Study is, of course, a survey of mutual fund distribution as it has existed and the resulting rule proposals are premised on the continuation of that system and the existing regulatory framework. The authors of the Study indicated that "If Section 22(d) were repealed and sellers were able to set the prices of funds at levels other than their current offering price described in the prospectus, then the analysis presented . . . needs to be re-evaluated".

C. Other Developments

In our Statement on the Future Structure of the Securities Markets we announced that the practice of investment company managers using portfolio brokerage of mutual funds to reward broker-dealers for sales of fund shares must be terminated. The NASD has published for comment an amendment to Article III, Section 26 of its Rules of Fair Practice designed to implement this policy and is moving ahead expeditiously to adopt the necessary rule change.

The Commission recently liberalized the rules with respect to advertising of investment company securities. In the release announcing the changes we described them as a modest first step in this direction and requested further suggestions. 1/ Several have been received and are now under consideration.

It also is timely now to renew consideration of group merchandising of fund shares at reduced sales loads, long a controversial subject. Rule 22d-1 permits quantity discounts to be provided in connection with the sale of a mutual fund to any person but excludes from the definition of "person" any group whose funds are combined for such purchase. In 1968, the Commission proposed a revision of this anti-grouping provision. 2/ That proposal was held in abeyance pending completion of our staff study of Section 22(d). The Commission has recently been asked to consider rule changes which would result in lower administrative costs on payroll deduction plans and other

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1/ Securities Act Release No. 5248, May 9, 1972

2/ Investment Company Act Release No. 5507, October 7, 1968

voluntary plans for accumulating mutual fund shares by means of periodic small purchases. These rules now require that shareholders receive individual notices, confirmations, dividend statements and shareholder reports. Our staff is exploring whether these rules can be revised without diminishing the basic shareholder protections they provide as well as re-examining the earlier grouping proposal and the comments received on it.

Issues to be considered

A. Repeal of Section 22(d) of the Act

1. Complete Repeal

The system of retail price maintenance under which mutual funds are distributed tends to raise rather than lower prices. Under it, fund distributors compete for the favor of dealers and salesmen through a system of sales incentives which creates a constant pressure to raise sales loads or reduce the principal underwriter's margin.

The question is whether there is any longer sufficient public interest in the continuation of this system as an exception to the general rule of free competition which prevails in most other segments of our economic life.

2. Partial Repeal

Should retail price maintenance be retained but only for smaller sales, allowing negotiated rates and free competition to prevail on that portion of any purchase in excess of a fixed amount, for example $300,000? Or, should a system of negotiated rates be instituted gradually over a period of time permitting data to be assembled as to the effects of repeal on various segments of the mutual fund market? If such gradual reductions are appropriate, can they be achieved under the Commission's exemptive power or would legislation be needed?

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3. Price Competition Within a Limited Range

Should retail price maintenance be retained with respect to a minimum schedule of sales loads, with the statute also specifying a maximum sales load, but allowing for price competition in the range between the specified maximum and minimum loads?

4. A Current Public Offering Price Described in the Prospectus

Section 22(d) states that "no registered investment company shall sell any redeemable security . . . except either to or through a principal underwriter for distribution or at a current public offering price described in the prospectus." Dealers are also required to sell at "a current public offering price described in the prospectus." There is no explicit requirement that there be a single uniform offering price, though that has been the long-standing interpretation of the provision. Would the statute be satisfied if the prospectus described different offering prices for different dealers or in different situations and thus permitted price competition in a manner sanctioned by the investment company itself?

5. Prohibit Price Competition from Non-Contract Dealers

Historically, a principal reason given for the enactment of Section 22(d) was the need to prevent price competition and secondary or "bootleg" markets made by non-contract dealers. Such dealers allegedly undermined the distribution structure by obtaining fund shares from sources other than the principal underwriters and selling them for lower prices than contract dealers could. In this way they could short-circuit the distribution process and destroy the underwriter's ability to promote the fund. Is it desirable or necessary to prevent this and, if so, if Section 22(d) is repealed should the legislation also provide that only contract dealers would be entitled to sell shares at prices other than the current offering price described in the prospectus?

B. Rules Under Section 22(b) and Other Provisions of the Act

1. Lower Breakpoints reflecting the Reduced Cost of Diversification on Larger Purchases

Section 22(b) of the Act gives the NASD and the Commission rule-making authority to prevent mutual funds being sold at a sales load which is excessive. Under that section, as amended, mutual fund sales charges must allow for "reasonable compensation for sales personnel, broker-dealers,

and underwriters, and reasonable sales loads to investors". It is clear that, whether or not Section 22(d) is repealed, mutual fund investors require the protection of a statutory ceiling on sales loads. One of the principles upon which the NASD study was based was that the cost of fund shares should not exceed the alternate cost of a similar investment. One measure of alternate cost used by the NASD's consultants was the round-trip cost of purchasing a diversified stock portfolio. However, on purchases in excess of $5,000 the alternate cost of diversification appears to be significantly less than the load suggested by the NASD rule proposal. Sales in excess of $5,000 accounted for about 70% of the total volume of mutual fund sales in 1970. Should any NASD rules take into account the reduced cost of diversification on purchases above the $5,000 level?

2. Regulation of the Dealer-Discount

The Commission in its Statement on the Future Structure of the Securities Markets expressed its concern over the effect of varying sales incentives available from different funds. In theory there seems to be widespread agreement that it is undesirable to allow an individual salesman to participate in the brokerage generated by an investment company complex whose funds he sells. The same kind of problem exists when fund distributors pay different dealer discounts. When one fund offers a dealer discount of 6 percent and another 8 percent, sellers are invited to recommend the fund that pays them best rather than the one that is best for their client. This practice also contributes to the pressure to raise sales loads or reduce the distributor's margin. Is this an area of concern and, if so, does the Commission have authority to deal with it by classifying as an "underwriter" under Section 2(a)(40) of the Act anyone who receives more than the "usual and customary distributor's or seller's commission" on the sale of mutual fund shares. In the alternative, should the NASD or the Commission take action under Section 22(b) to limit dealer discounts? If dealer discounts should be limited, in what respects?

3. Continuous Discounts

Under existing sales load structures purchasers of large volumes of mutual fund shares receive a volume discount when purchases are made in amounts exceeding specified breakpoints, e.g., $10,000, $25,000 or $50,000. The reduced charge applies to the entire purchase, not merely to the portion in excess of the breakpoint. This means that for a fund with a basic sales charge of 8.5% which drops to 7.5% on purchases in excess of $10,000 or more, a $9,900 purchase will produce gross revenue of $841.50 for the selling organization. If the purchase were $100 greater, i.e., $10,000, total selling compensation drops to $750. Such a system discourages sellers from alerting prospects to the economies produced by breakpoints and places ethical strains on dealers and salesmen. Should Rule 22d-1 be amended to require that volume discounts be provided only where continuous schedules are in effect under which reductions fall only on that portion of the order in excess of the breakpoints?

4. The Value of Additional Product Features

The NASD Study suggests that the maximum load be determined by the value of the product and that only those funds which offered certain product features -- dividend reinvestment at net asset value, lower breakpoints for volume discounts and dividend reinvestment at net asset value -- should charge the maximum loads. Is this a desirable approach in the light of the fact that a significant proportion of investors do not take advantage of these features? Is this approach desirable assuming a system of continuous discounts?

5. Contractual Plans

The total sales loads on contractual plans and the breakpoints on such plans are higher than the typical loads and breakpoints on mutual funds generally. The effective load on contractual plans may be significantly higher when the effects of lapses and persistency is taken into account. Is it premature at this time to take any action with respect to maximum sales charges applicable to contractual plans in light of the changed conditions in which the plan industry now operates, and in view of the protections afforded to contractual planholders by amended Section 27 of the Act?

C. Further Liberalization of Advertising Rules

1. Advertising

Advertising, an effective and a relatively low-cost method of conveying information to prospective purchasers, has been confined to a minimal role in the marketing of investment company securities. Restrictions on advertising have made it difficult for the mutual fund industry to tell its story through the mass media. The Commission recently liberalized its rules with respect to the advertising of investment company securities. What further liberalization would be in order? Is legislation necessary in this area?

2. Statement of Policy

The Statement of Policy which governs investment company advertising and sales literature has not been amended since 1957. A number of its basic approaches have been questioned over the years. These include limitations on projections, use of mountain charts to convey cumulative performance, prohibitions against a total yield approach, absence of data upon which to base conclusions as to average annual performance and variability of performance from year to year. To what extent are these elements of the Statement of Policy no longer appropriate?

D. Simplified More Readable Mutual Fund Prospectuses

Advertising restrictions rest on the premise that the statutory prospectus will be the key selling document. However, selling practices typically relegate the prospectus to a secondary role and very often legal requirements result more in confusing the ordinary investor than assisting him in reaching an informed judgment. The Commission has designated an Advisory Committee to make suggestions with respect to this and related subjects. Assuming simple clear prospectuses geared to the ordinary mutual fund investor's needs, will the prospectus be used more extensively and earlier in the distribution process and will this affect selling?

E. Group Sales

Mutual fund sales charge schedules provide for quantity discounts on larger orders. But the Commission's rules under section 22(d) preclude the grouping or pooling of orders for the purpose of obtaining such discounts. Has this anti-grouping rule, which superseded contrary administrative positions, outlived its usefulness?

F. Reducing Paperwork in Small Transactions

Payroll deduction plans and other voluntary plans for accumulating mutual fund shares by means of periodic small purchases appear to offer great potential. Some of the present rules under the federal securities laws make such plans expensive. The rules in question require that each fund shareholder receive such individual notices and services as individual confirmations, dividend statements and shareholder reports. To what extent can the Commission amend these rules to achieve lower costs on small transactions without diminishing the basic investor protections they provide?

G. No-Load Sales

Under present administrative interpretations brokers and dealers have no direct incentive to recommend "no-load" funds, i.e., funds that sell their shares directly to the public free from any sales charge. The imposition of any charge for recommending the shares or for effecting the purchase of such a fund, especially if the fund encourages or has knowledge of the practice, has been viewed as an impermissible deviation from the prospectus representations as to no-load status as well as a violation of Section 22(d). Should the Commission re-examine its present administrative interpretations in order to remove disincentives operating against recommending no-load funds? Should it permit brokers and dealers to charge a normal stock exchange commission for recommending and effecting an investment in a no-load fund?

H. Development of An Adequate Economic Data Base

If mutual fund sales charges are to be regulated, reliable data as to the industry's costs, profitability, and general economic structure is necessary. Such data should be available on a continuous basis so as to enable the regulators to monitor trends, thus avoiding the undue regulatory lag that has plagued other types of regulation. Is it possible to develop a system of cost allocation and other accounting procedures necessary to provide such data in a meaningful fashion? What burdens would be involved in moving the industry to such a uniform system?

Procedures

The policy implications of these and other related questions are of great significance to the securities industry generally and particularly to investment companies, their principal underwriters, the broker dealers and salesmen who distribute them, and to the investing public. Accordingly, all persons interested in, affected by or concerned with the distribution of investment company shares and the role of investment companies in the securities markets are invited to provide their views to the Commission with respect to all such issues.

The proposed public hearings will be policy making proceedings. They are designed to give the Commission further insight into the major issues and alternatives facing the industry in the area of mutual fund distribution in order that the Commission may formulate its own legislative recommendations, propose new rules and amend existing rules to the extent appropriate under its present authority. Of course, as in so many areas of the securities laws, the issues are largely interrelated and actions in one respect may deeply affect others. Thus, the full impact of a particular rule or legislative change may be difficult to gauge and all of the questions raised will not be resolved definitively at one time.

These hearings are concerned with the formulation and establishment of policy and the rules necessary to implement it. The procedures will be tailored to this end. Because of the wide ranging scope of the inquiry it appears appropriate and expeditious to require written submissions in the first instance. Comments should be addressed to the enumerated questions or other relevant issues the commentator may care to call to the Commission's attention. Persons commenting may feel free to submit any relevant data or other information relating to these issues, and reference may be made, where appropriate, to the Commission's Staff Study, the NASD Study, to prior hearings, policy statements or testimony. All such submissions will be available for public inspection. After the Commission has had a chance to review all submissions, brief oral statements will be invited from among those who have made submissions and requested to be heard. Persons making oral presentations should be prepared to respond to inquiries from the Commission and its staff.

Interested persons are requested to submit their views, any data or other comments or information in triplicate, to Allan S. Mostoff, Director, Division of Investment Company Regulation, Washington, D.C. 20549, no later than December 6, 1972. All such material should be designated "Mutual Fund Distribution Hearings", File No.4-164.

By the Commission.

Ronald F. Hunt
Secretary

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

INVESTMENT COMPANY ACT OF 1940
Rel. No. 7635/January 18, 1973

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 9958/January 18, 1973

INVESTMENT ADVISERS ACT OF 1940
Rel. No. 357/January 18, 1973

ACCOUNTING SERIES
Rel. No. 140/January 18, 1973

DISCUSSION OF DEVELOPMENT OF AN ADEQUATE ECONOMIC DATA BASE WITH RESPECT TO MUTUAL FUND SALES CHARGES IN CONNECTION WITH HEARINGS ON MUTUAL FUND DISTRIBUTION AND THE POTENTIAL IMPACT OF THE REPEAL OF SECTION 22(d) OF THE INVESTMENT COMPANY ACT OF 1940 (15 U.S.C. 80a-22(d))

File No. 4-164

On November 3, 1972, the Commission announced hearings on mutual fund distribution and the potential impact of the repeal of Section 22(d) of the Investment Company Act of 1940 (Investment Company Act Rel. No. 7475; 37 FR 24449, 11-17-72). Section H of that release discussed the desirability of developing an adequate economic data base with respect to mutual fund sales charges. Such data could facilitate the Commission in monitoring trends in the industry's costs, profitability, and general economic structure. If this data were made publicly available by the Commission on a timely basis, it could provide mutual fund directors with information which would be of value to them in the discharge of their duty in evaluating investment advisory and principal underwriting contracts. A threshold question is whether it is necessary to develop procedures for the full allocation of expenses to revenue in order for the Commission and mutual fund directors to discharge their responsibilities. In this connection, particular attention is called to the December 29, 1972, report to the Commission by the Advisory Committee on Investment Companies and Advisers. Of course, in order to embark on any such program of data collection analysis and dissemination, the Commission would have to develop adequate staff resources and review capability.

This release is intended to provide a focal point for discussion during the hearings and to articulate some of the possible approaches in this area.

A. Investment Advisers and Principal Underwriters

I. Information Presently Available

Information currently available concerning the financial environment of mutual fund management companies is both incomplete and inconsistent in terminology and format. For example, Form 10-K's (17 CFR 249.310), which contain financial schedules, are filed by publicly-held investment advisers and principal underwriters, but most investment advisers and principal underwriters are not publicly held and therefore do not file such information. Furthermore, although the information contained in the Form 10-K's permits an evaluation of profitability, it does so only for total operations, which often include non-mutual fund operations such as real estate or insurance. The terminology used within the income statement is often inconsistent from one company to another. For example, "Management fees, etc." may include fees other than investment company advisory fees. Expense items are usually consolidated under accounting titles too general to permit an outsider to relate such expenses to a specific revenue source.

Form N-1R, (17 CFR 274.101) filed by most registered management investment companies, provides information on the gross revenue received by an investment adviser and principal underwriter from advisory fees and from underwriting operations. Although in certain circumstances income statements of the investment adviser or principal underwriter are required in the report, a breakdown of expenses between underwriting and advisory functions is not required.

II. Data Base Desirable

A. Background

The "Economic Study of the Distribution of Mutual Funds and Variable Annuities" released by the NASD in May 1972 suggested that expenses were an unreliable element in determining the reasonableness of mutual fund sales charges. These expenses are difficult to measure precisely; past expenses are not necessarily a measure of future expenses; and expenses need not be functionally related to income since expenses in one area may be incurred to obtain revenue for an unrelated function. For example, expenses may be incurred in underwriting to obtain future revenue through increased advisory fees. While this may be presently the case, it may nevertheless be feasible to develop an income and expense reporting system for the industry which could facilitate future economic analyses.

B. Functional Breakout

1) Underwriting v. Advisory Expenses

Is it feasible and desirable to account separately for the profitability of distributing and advising mutual funds? Would such a separation be helpful to management or to shareholders in measuring relative profitability of the advisers or underwriter's operations? What burdens on management would the requirement for separate accounting produce?

2) Areas of Profitability

One approach to constructing a data base to provide a meaningful delineation of profits would be to require separate identification of income and expenses for particular functions of investment companies such as:

(a) sales charges (gross or net) from underwriting,

(b) sales charges from retailing,

(c) fees for investment advisory services,

(d) fees for administrative services,

(e) income from brokerage generated by an investment company's portfolio transactions, and

(f) other income.

3) Components

The components of each function could be accounted for separately to show (a) revenue items, (b) direct expenses and (c) indirect expenses.

(a) Revenue. Can gross revenue be identified for each income area of concern?

(b) Direct Expenses. Some expenses are directly attributable to specific revenue producing functions and can be identified with them if records adequate for the purpose are maintained. Such expenses could include:

(i) sales charges paid to dealers,

(ii) sales representatives' compensation,

(iii) salaries of other sales department personnel,

(iv) sales promotional expense,

(v) salaries of investment research personnel -- analysts, economists, statisticians, etc., and

(vi) cost of execution facilities for brokerage.

Is accounting or recordkeeping for direct expenses maintained in such a way as to permit an accurate breakdown of such expenses among functions? If not, would it be practical and how costly would it be to do this?

(c) Indirect Expenses. Various expenses cannot be assigned directly to a single function. These must be allocated, at least in part, among functions to arrive at separate profit figures. Such expenses could include:

(i) salaries (for executives engaged in more than one function),

(ii) general administration expenses,

(iii) occupancy and equipment expense,

(iv) depreciation and amortization,

(v) dues, fees and assessments paid to exchanges, associations and regulatory agencies,

(vi) interest expense,

(vii) income taxes and other taxes, and

(viii) other allocable expenses.

What is the most reasonable method for allocating these expenses? Since indirect expenses must be allocated with some discretion, there are various methods that could be considered. For example, could they reasonably be allocated on the basis of total direct expenses incurred by the various revenue producing functions? Could direct labor hours, total payroll dollars or revenue dollars received from each function serve as a basis? Could a method of allocation be devised separately by each firm on the basis of "reasonableness," and sufficient consistency within the industry still be maintained? What approaches would result in a fair statement of profits among functions and a reasonable degree of consistency throughout the industry? Should such approaches be subject to Commission or NASD approval?

4) Other Expense Considerations

Is it relevant to break down expenses to the individual fund level? Certain management expenses are now allocated among funds in a complex based on each fund's assets relative to the total assets of the advisory complex. However, many complexes consist of funds of varying sizes and with different investment objectives, and management effort may not be actually expended in direct proportion to asset size. Under these circumstances, should some basis other than relative assets be devised?

III. Reporting

Would a periodic report by principal underwriters and advisers of investment companies, stating the revenues, expenses and profits associated with each revenue producing function be the most effective means of disclosure? What would be the least burdensome method of such disclosure? Revision of an existing report form to provide for the submission of additional financial information could be considered. The alternatives available are:

A. Form N-1R (17 CFR 274.101). This report is now submitted by most management investment companies and is generally reviewed by the directors of mutual funds. Also, the Form N-1R has been designed for computer entry and would thus lend itself to statistical study. However, is a report submitted by the funds a proper vehicle for reporting profit data of the management and principal underwriting organizations?

B. Form 10-K (17 CFR 249.310). This report, by its nature, lends itself most easily to the type of information required. However, it is filed by only a small percentage of mutual fund management and principal underwriting organizations and would thus provide only a limited sampling.

C. Form ADV (17 CFR 279.1). The registration statement of investment advisers would permit the management to report in a more direct fashion than a vehicle such as Form N-1R which is submitted by the funds. However, Form ADV is filed by all registered investment advisers, not just those which advise mutual funds. Further, Form ADV is required to be filed only once and updated only when any of the information becomes inaccurate. The Advisory Committee on Investment Companies and Advisers has recommended that this form be filed on an annual basis and revised and expanded to serve as the basic adviser reporting form. If the resources necessary for the monitoring and utilization of the data were available, would the recommended replacement report be a proper reporting instrument?

D. Form X-17A-10 (17 CFR 249.618). This report is the basic source of financial information concerning the operations of broker-dealers and is filed annually by all broker-dealers with at least $20,000 of gross securities income. The report requires the disclosure of details of income but does not allocate expenses. It is submitted for the calendar year on a non-public basis. Should this form be amended to include profit data for underwriting and managing mutual funds? Or, should such information be obtained more directly since the brokerage business may be only a small part of a larger mutual fund operation and may be organized separately?

* * *

In light of the limitations of each of these reports, should a new report format be devised which would be used only by the principal underwriter and adviser to mutual funds? In order to be useful to all concerned, the data must be reported in a timely manner. This would permit monitoring earlier in the development stage of new trends. Would an annual basis be the proper interval? Would fiscal year rather than calendar year be preferable?

B. Broker-Dealers

Many of the considerations in the foregoing discussion relating to the profitability of managing and underwriting mutual funds apply also to broker-dealers engaged in the retail sale of mutual fund shares.

The sale of mutual fund shares generally represents a relatively small percentage of the gross revenues of broker-dealers. However its relative significance to them cannot be evaluated since reported expenses are not allocated to this and other revenue sources. For example, is the profit per dollar of revenue or per transaction greater or less than the profit on other segments such as commission business or underwriting, particularly of such competing investment products as closed-end funds and certain real estate and tax shelter investments? Could the necessary allocation methods suggested in the instructions to the New York Stock Exchange revised Income and Expense Reporting Form be adapted for this purpose?

For those broker-dealers to whom revenue from the sale of mutual funds constitutes a high percentage of gross revenue, there should not be a problem in ascertaining costs allocable to those sales; however, these represent only a relatively small fraction of the total number of brokers. Does allocation of expenses become more difficult in larger concerns which conduct a diversified securities business in which the sale of mutual fund shares is only one of several sources of revenue? For such a firm, can certain direct expenses, such as sales executivies and employees compensation and sales promotion, be related to a revenue source? Is the current practice with respect to allocation sufficient to impart an appropriate understanding of the relative significance to such firms of the retail sales of mutual fund shares?

This discussion is not intended to represent a formal proposal for a rule amendment but rather only to stimulate additional comments during the forthcoming hearings.

By the Commission.

Ronald F. Hunt
Secretary

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

November 6, 1972

TO: All NASD Members and Interested Persons

RE: Proposed Amendments to Regulations Governing Sales Charges on Mutual Fund Shares and Variable Annuity Contracts

1. Proposed Amendments to Subsections (a) and (d) of Article III, Section 26 of Rules of Fair Practice

2. Proposed Amendment to Subsection (c) of Article III, Section 29 of Rules of Fair Practice

The Board of Governors of the Association has proposed amendments to existing regulations, as referenced above, which are being published at this time to enable all interested persons to comment thereon. Such comments must be in writing and received by the Association on or before December 6, 1972, in order to receive consideration. After the comment period has closed, the proposed amendments must again be reviewed by the Board taking into consideration the comments received. Thereafter, upon approval by the Board, they must be submitted to the membership for a vote. If approved, the proposals must be submitted to and not disapproved by the Securities and Exchange Commission prior to becoming effective.

The authority for these proposals is contained in Section 15A (b) (8) of the Securities Exchange Act of 1934, as amended (the Maloney Act), 15 USC 78o-3 (b) (8); Section 22 of the Investment Company Act of 1940, as amended, 15 USC 80a-22, and Article VII of the Association's By-Laws.

Background and Explanation of Proposals

Under the 1970 Amendments to Section 22 (b) of the Investment Company Act of 1940, the NASD has the obligation to formulate and enforce rules preventing sales charges on mutual fund shares which are "excessive". In establishing such rules, the allowance of "reasonable compensation for sales personnel, broker-dealers, and underwriters", and the imposition of "reasonable" sales charges for investors is specifically provided for in the legislation. To assist

in the objective formulation of sales charge rules, the Association engaged a firm of independent consultants to undertake an intensive "Economic Study of the Distribution of Mutual Funds and Variable Annuities" ("Study") with the objective of formulating criteria for the appraisal of sales charges in light of all relevant factors.

As originally understood, the Study was to have covered sales charges only for open-end investment company shares. However, at the request of the SEC, the scope of the Study was widened to include contractual plans and variable annuity contracts, as well as consideration of alternative methods of distributing mutual fund shares. All phases of the Study have now been completed. Without necessarily endorsing all aspects of the Study, the Association has, after review of the Study facts and conclusions, accepted the regulatory approach recommended by the consultants and the proposed amendments to Article III, Sections 26 and 29 of the Association's Rules of Fair Practice.

The guiding considerations that underlie the proposed rules are the protection of investors and the maintenance of an industry structure that will promote services of a high quality. To insure these objectives, the proposals are not the result of a particular formula, but reflect a judgmental weighing of factual evidence bearing on the following four standards used for evaluation of the reasonableness of the sales charges:

1. Effective competition: Competition may take the form of price and product competition. The Association is directing its regulatory authority, as a supplement to market forces, toward remedying imperfections in the market so as to assure a price-product structure consistent with effective competition. The objective is to maintain a sales charge structure where the sales charge declines as the size of the purchase increases and where higher sales charges are accompanied by better terms.

2. Value of Service: Charges to the investor must not exceed the value provided to the investor by diversification plus: (a) the value of various product features; and (b) the value of services rendered coincident with the sale of investment company securities. The value to the investor is measured by the cost that the investor would incur if he sought on his own to purchase the benefits and services he received through the acquisition of investment company securities.

3. Salesmen's Compensation: Sales charges must allow for compensation levels that are sufficient to attract personnel commensurate with the quality of the service required, giving consideration to the time spent in the selling effort, the level of education, and professional experience of sales personnel.

4. Cost of Distribution: Sales charges should be sufficient to cover the costs incurred by underwriters and broker-dealers plus

a reasonable allowance for profit. The relevant costs are those functionally related to the sales of investment company securities within an industry structure characterized by a sufficient number of efficiently managed large and small firms to insure effective competition.

The results of the application of these standards, both in terms of conclusions expressed in the Study and in terms of the relationship of these conclusions to the proposed amendments to the rules, are discussed separately as they relate to sales charges on mutual fund shares, variable annuity contracts, and contractual plans.

Sales Charges on Mutual Fund Shares -- Proposed Amendments to Section 26

Proposed Amendment to Subsection (a)

The proposed amendment to subsection (a) of Section 26 is a conforming amendment necessitated by those provisions contained in the proposed amendments to subsection (d) pertaining to "single payment" investment plans issued by a unit investment trust registered under the Investment Company Act of 1940.

Proposed Amendment to Subsection (d)

The proposed amendment to subsection (d) of Section 26 would prevent members from selling shares of an open-end investment company or a single payment investment plan issued by a unit investment trust registered under the Investment Company Act of 1940 if the public offering price includes a sales charge which is excessive taking into consideration all relevant circumstances. Following this general prohibition are several provisions which if not conformed to would deem a sales charge to be excessive. These provisions were developed taking into consideration the four regulatory criteria discussed above.

The application of the four regulatory criteria to the distribution of mutual fund shares reflects the following:

1. Effective Competition: During the decade of the 1960's, the competitive forces in the industry brought about significant improvements in the terms on which investors are able to acquire mutual funds. The Study clearly indicates that there has been a decline in the minimum purchases needed to benefit from quantity discounts; the availability of cumulative quantity discounts has become more widespread; an increasing proportion of funds offer reinvestment of dividends without sales charges; and exchange and combination privileges are now offered by virtually all underwriters selling several funds. These improvements in the terms, together with other factors, have resulted, despite a rise in maximum sales charges, in a 30 percent decline in the average sales charge to

investors, from 6.3 percent in 1960 to 4.4 percent in 1970. The investor has also benefited from lower minimum purchase requirements, a widespread offering of retirement plan services, and an improvement in the conditions of eligibility for withdrawal plans.

While the Study shows that the price-product structure is generally consistent with conditions of effective competition, the proposed amendments to subsection (d) of Section 26 are intended to improve competition in the following areas:

(a) The disparities in maximum sales charges among the various funds were not generally found to be product related; i.e., funds with a higher maximum sales charge do not generally offer better terms than funds with a lower maximum. Proposed subsection (d) (1) of Section 26 therefore prohibits sales charges which exceed an established maximum level under any circumstances.

(b) The Study revealed that a significant proportion of mutual funds offering reinvestment of dividends at regular sales charges do not have lower maximum sales charges or offer better terms than funds offering dividend reinvestment without sales charges (i.e., at net asset value). Consequently, proposed subsection (d) (2) of Section 26 provides that if reinvestment of dividends at net asset value is not offered, there shall be a stated reduction from the maximum sales charge otherwise authorized. If dividends are reinvested at net asset value, a reasonable service fee may be charged for each dividend reinvestment transaction.

(c) According to the Study, a significant proportion of mutual funds that do not offer cumulative quantity discounts to individuals do not have lower maximum sales charges or offer investors better terms than funds that do offer such discounts. Accordingly, proposed subsection (d) (3) of Section 26 provides that if cumulative quantity discounts are not offered, there shall be a stated reduction from the maximum sales charge otherwise authorized.

(d) The Study found considerable variance in the discounts granted for volume purchases. As a result, proposed subsection (d) (4) of Section 26 establishes minimum standards for quantity discounts for the first and second gradations, or breakpoints. If the quantity discounts offered do not meet these minimum standards, there shall be a stated reduction from the maximum sales charge otherwise authorized.

The reductions in maximum sales charge required by the above proposals are cumulative so that if, for example, none of the specific services offered meet the minimum requirements of the rule, the maximum permissible sales charge on any transaction would be 6 percent.

2. Value of Service: The Study supports the conclusion that the proposed rule amendments will result in a structure of sales charges where the value of service received by the investor exceeds the cost of acquisition, giving consideration to the diversification needed to reduce risk, the benefit of other product features, and the services rendered by salesmen. This is particularly true for the smaller investors.

3. Salesmen's Compensation: The Study shows that relatively few salesmen earn substantial incomes from the sales of mutual fund shares. It is pointed out as well that, in relation to the sales effort involved, the structure of sales charges does not permit or encourage "excessive" compensation to mutual fund salesmen.

4. Cost of Distribution: According to the Study, the existing structure of sales charges did not provide "excessive" compensation for underwriters or broker-dealers in recent years. Moreover, in 1970, the last year for which data are available, only the largest, diversified, broker-dealer firms achieved profitable operations from their mutual fund business.

The proposed rule amendments are in the form of alternatives and have been limited to the four most important variables that bear on the effective sales charge paid by investors: the maximum sales charge, quantity discounts, dividend reinvestment, and rights of accumulation. The proposals are intended to be sufficiently flexible to permit adjustments based on an assessment of changing competitive conditions in the particular market that is served and to allow innovations in product features, services, and distribution methods.

It is recognized that other aspects, such as exchange and combination privileges, and letters of intent, also influence the effective sales charges. The Association intends to keep these and other product features offered under surveillance and, if necessary, make such features the subject of specific rules. The surveillance is intended to guard against attempts to circumvent the effect of the proposed amendments by changing the terms on which product features are now offered to investors or by instituting charges or special fees for the redemption of outstanding mutual fund shares, or for other services or features not covered specifically in the proposed rule amendments.

Sales Charges on Variable Annuities -- Proposed Amendments to Section 29

In view of the fact that variable annuities differ substantially from mutual funds, particularly with respect to industry structure,

degree of maturity, regulatory aspects, and price-product characteristics, separate rules are required for variable annuity sales charges. Nevertheless, the same four criteria or standards of regulation are relevant to an appraisal of sales charges in order to protect the investor and assure the viability of the variable annuity industry. Important considerations, too, in formulating the rules are the "infant industry" status of the variable annuity business and the dual nature of the product (i.e., securities and insurance) resulting in a complex regulatory framework that involves the SEC, State Insurance Commissioners, and the NASD.

With respect to the four regulatory criteria adopted, some primary Study conclusions and their relationship to the proposed rules follow:

1. Effective Competition: Given the present degree of industry maturity, competition is generally developing satisfactorily with respect to rate of entry and on a price-product basis. Because of the "infant industry" status of the industry, the nature of developing competition rather than the status of existing competition, is the relevant yardstick. The Study concluded as well that the existing level of charges on variable annuities generally is not excessive either from the investor's or the industry's viewpoint.

However, the existence of certain market imperfections was disclosed by the Study, which the Association's proposed rules are intended to remedy:

(a) A wide diversion of prices and price structures currently exists in a market where higher sales charges may not always be accompanied by better terms. Consequently, proposed subsection (c) (1) of Section 29 provides that sales charges on variable annuity contracts shall not exceed an established percentage of purchase payments in the first twelve contract years.

(b) It was brought out in the Study that approximately three-fourths of single payment variable annuity contracts provide for graduated sales charges based on the size of purchase payments. Therefore, proposed subsection (c) (2) of Section 29 requires that a specific minimum scale of graduated sales charges be offered.

(c) In a very few contracts, deductions from purchase payments are not separated according to the nature of the expenses that they cover. Consequently, the Study concluded that in such cases it is not possible to determine what part of the charge is for sales and what part is for administrative expenses. Proposed subsection (c) (3) of Section 29 therefore requires that if the charges are not stated separately,

the total charge shall be regarded as a sales charge and brought within the established limitations.

(d) A further conclusion of the Study was that future competition may be enhanced through the establishment of more stringent disclosure requirements and lifting of the current "blanket" restrictions on hypothetical illustrations. The Association agrees with that conclusion; however, it is believed that these issues will require additional work and separate recommendations by the Association to the SEC.

2. Value of Service: It was concluded that the value of service provided to investors by variable annuities through portfolio diversification and dividend reinvestment alone, i.e., without consideration of any other product features, exceeds the sales charge for most plan purchasers. This conclusion is based on calculations using the average monthly purchase payment of approximately $100 under periodic payment variable annuity contracts. Moreover, variable annuities provide a "bundle" of product features, which cannot be assembled through alternative retirement-planning instruments at the present time.

3. Salesmen's Compensation: The Study concluded that compensation earned by full-time agents on sales of variable annuity contracts is not excessive when compared with compensation from available alternative sources.

4. Cost of Distribution: Because of the newness of variable annuity operations for most carriers, costs of these operations could not be considered in the Study as an appropriate standard for regulating sales charges. Current costs are not representative of future long-term costs and owing to the product mix of carriers there are limitations in distinguishing those costs arising from variable annuity operations. The Study makes clear from available cost data, however, that current sales charges fall far short of covering current distribution costs.

The conclusions reached in the Study, and the proposed amendments to Section 29 regarding sales charges on variable annuities, are largely influenced by the early stage of development of variable annuity operations. Consequently, they must be re-evaluated as regulatory experience is gained in this area and as the industry grows. However, the Association believes that the proposed rule will have a strengthening influence on competition in the course of future industry development.

Too, the proposed rule addresses only the maximum sales charge and the structure of sales charges. It has been formulated in light of the belief that the Association has no jurisdiction over charges made against purchase payments other than sales charges. Such other

charges would include those for administration and those for investment management and for the mortality and expense risks assumed by the insurance company, that are generally made against the assets of the separate account. The Association understands that the SEC has already assumed surveillance over charges for administration and in most instances requires issuers of variable annuities to disclose in their prospectuses that charges for administration will not exceed the cost of providing administrative services.

Contractual Plans

One of the principal areas of regulation changed by the 1970 Amendments to the Investment Company Act was the regulation of periodic payment contractual plans, particularly the levels of first year sales charge deductions on such plans.

Specifically, amended Section 27 of the Act provides a contractual plan sponsor with the choice of offering the conventional periodic payment contractual plan with up to 50 percent of the sales charge deducted from the first year's payments, but only if coupled with a refund offer to the planholder of his entire sales charge plus the underlying net asset value of the related mutual fund shares if requested 45 days from the start of the plan (this provision being commonly referred to as the 45-day "free look" privilege), and the right to receive a refund within 18 months after the start of the plan representing any excess paid for sales charges over 15 percent of the payments made by the planholder to that date plus the net asset value of his shares. Alternatively, the sponsor may offer a spread-load plan, pursuant to which not more than 20 percent of any payment may be deducted for sales charges from any of the first 36 monthly payments and not more than an average of 16 percent may be deducted from the first 48 monthly payments. Under this spread-load alternative, the sponsor is also required to offer the 45-day free look privilege.

As authorized by Section 27, the Commission also prescribed forms of notice to be furnished with the refund offers and substantial reserve requirements for plan sponsor companies with respect to the refund obligations. These new provisions were added to provisions in the original 1940 Act which, among other matters, fixed a 9 percent maximum sales charge on the total payments to be made and provided that not more than one-half of the first twelve monthly payments, or their equivalent, could be deducted for sales charges.

The Study clearly demonstrates that the amendments to Section 27 have contributed to major changes in the structure of the contractual plan industry, as described in the Study. As recently as early 1970, there were approximately 50 contractual plan sponsors offering 77 separate periodic payment contractual plans; at the beginning of 1972, only 30 sponsors were offering 49 separate plans. Prior to the 1970 Amendments, only one sponsor offered periodic payment contractual

plans on a spread-load basis; at the beginning of 1972, 21 of the 49 contractual plans still being offered were available on a spread-load basis. However, due to the limited amount of time that had elapsed since passage of the 1970 Amendments, the Study could not reflect either comprehensive data relating to the distribution of new contractual plan sales as between front-end and spread-load plans, or comprehensive data relating to the cost impact on plan sponsors associated with compliance with the provisions of amended Section 27. Moreover, since compensation arrangements of many plan sponsors and broker-dealers were still in a state of flux, it was impossible to assemble meaningful data with respect to the changes which have taken place in modes of compensation to sales personnel and broker-dealers on new plan sales as a result of the Amendments, and the consequences of such changes in sales incentives.

One of the most significant factors contributing to these changes, as recognized by the Study, is the 18 month refund provision. The first 18 months after the effectiveness of the Act will not have passed until December 14, 1972, and it will only be sometime thereafter, when analyses can be made of the significance of refunds during successive 18 month periods, changes in levels of compensation, and changes in the level and distribution of new sales between front-end load and spread-load plans, that the impact of the refund provision on the viability of the plan industry can be measured.

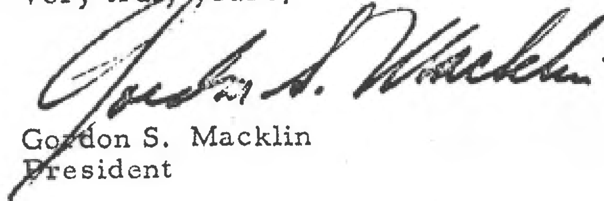
In these circumstances, and in view of the protection afforded to planholders by amended Section 27 of the Act, the Board has decided to defer the formulation of rules with respect to sales charges on periodic payment contractual plans until sufficient time has elapsed to permit an assessment of the impact of the amendments on the contractual plan industry and a determination of whether the level and structure of sales charges meet the standards specified by Section 22 (b) of the Act. While the proposed rules do not therefore apply to periodic payment plans, the Association will be monitoring further developments in the industry and rules may be necessary at some future time.

With respect to single payment contractual plans, the application of the four standards or criteria of regulation (i.e., effective competition, value of service, salesmen's compensation, and cost of distribution) led to conclusions similar to those drawn from the Study with respect to open-end investment company shares. Since these plans were essentially unaffected by the 1970 Amendments, the proposed amendments to Section 26 would apply to single payment contractual plans as well as regular purchases of mutual fund shares.

Comments on the proposed rules should be addressed to Mr. Donald H. Burns, Secretary, National Association of Securities

Dealers, Inc., 1735 K Street, N. W., Washington, D. C. 20006, on or before December 6, 1972. All communications will be considered available for inspection.

Very truly yours,



Gordon S. Macklin
President

Text of Proposals

Proposed Amendment to Article III, Section 26 of Rules of Fair Practice

New material indicated by underlining
Deleted material indicated by striking out

Subsection (a) of Section 26 is proposed to be amended as follows:

(a) Except for the provisions of subsection (d), this rule shall apply exclusively to the activities of members in connection with the securities of an "open-end management investment company" as defined in the Investment Company Act of 1940.

Subsection (d) of Section 26 is proposed to be amended as follows:

~~Gross-Selling-Commission~~ Sales Charge

(d) No member ~~who is an underwriter~~ shall ~~participate in the~~ offer~~ing~~ or ~~in the sale~~ sell ~~of any such security~~ the shares of any open-end investment company or any "single payment" investment plan issued by a unit investment trust registered under the Investment Company Act of 1940 if the public offering price includes a ~~gross selling commission or load (i.e., the difference between the public offering price and the price received by the issuer)~~ sales charge which is ~~unfair~~ excessive, taking into consideration all relevant circumstances. ~~including the current marketability of such security and all expenses involved~~ Sales charges shall be deemed excessive if they do not conform to the following provisions:

(1) The maximum sales charge on any transaction shall not exceed 8.50% of the offering price.

(2) (a) Dividend reinvestment shall be made available at net asset value per share to "any person" who requests such reinvestment within 20 days prior to payment date, subject only to the right to limit the availability of dividend reinvestment to holders of securities of a stated minimum value, not greater than $1,200, and provided that a reasonable service charge may be applied against each reinvestment of dividends.

(b) If dividend reinvestment is not made available on terms at least as favorable as those specified in

subsection (2) (a), the maximum sales charge on any transaction shall not exceed 7.25% of offering price.

(3) (a) Rights of Accumulation (cumulative quantity discounts) shall be made available to "any person" for a period of not less than ten (10) years from the date of first purchase in accordance with one of the alternative quantity discount schedules provided in subsection (4) (a) below, as in effect on the date the right is exercised.

(b) If Rights of Accumulation are not made available on terms at least as favorable as those specified in subsection (3) (a), the maximum sales charge on any transaction shall not exceed:

(1) 8.0% of offering price if the provisions of subsection (2) (a) are met; or

(2) 6.75% of offering price if the provisions of subsection (2) (a) are not met.

(4) (a) Quantity discounts shall be made available on single purchases by "any person" in accordance with one of the following two alternatives:

(1) A maximum sales charge of 7.75% on purchases of $10,000 or more and a maximum sales charge of 6.25% on purchases of $25,000 or more; or

(2) A maximum sales charge of 7.50% on purchases of $15,000 or more and a maximum sales charge of 6.25% on purchases of $25,000 or more.

(b) If quantity discounts are not made available on terms at least as favorable as those specified in subsection (4) (a), the maximum sales charge on any transaction shall not exceed:

(1) 7.75% of offering price if the provisions of subsections (2) (a) and (3) (a) are met;

(2) 7.25% of offering price if the provisions of subsection (2) (a) are met but the provisions of subsection (3) (a) are not met;

(3) 6.50% of offering price if the provisions of subsection (3) (a) are met but the provisions of subsection (2) (a) are not met;

(4) 6.00% of offering price if the provisions of subsections (2) (a) and (3) (a) are not met.

(5) The term "any person" as used in this rule shall mean "any person" as defined in Rule 22d-1 (a) under the Investment Company Act of 1940.

Proposed Amendment to Article III, Section 29 of Rules of Fair Practice

New material indicated by underlining
Deleted material indicated by striking out

Subsection (c) of Section 29 is proposed to be amended as follows:

Sales ~~Load~~ Charges

(c) No member shall participate in the offering or in the sale of variable annuity contracts if the purchase payment includes a sales ~~load~~ charge which is ~~unfair~~ excessive: ~~taking into consideration all relevant circumstances~~.

(1) In contracts providing for multiple payments a sales charge shall not be deemed to be excessive if the contract provides for a sales charge which will not exceed 8.5% of the total payments to be made thereon as of a date not later than the end of the twelfth year of such payments, provided that if a contract be issued for any stipulated shorter payment period, the sales charge under such contract shall not exceed 8.5% of the total payments thereunder for such period.

(2) In contracts providing for single payments a sales charge shall not be deemed to be excessive if the contract provides for a scale of reducing sales charges related to the amount of the purchase payment which is not greater than the following schedule:

First $25,000 - 8.5% of purchase payment
Next $25,000 - 7.5%
Over $50,000 - 6.5%

(3) In contracts where sales charges and other deductions from purchase payments are not stated separately, the total deductions from purchase payments (excluding those for insurance premiums

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Orville H. Lauver, President

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Ted Davis, Vice President

FAMILY INCOME PLANNING, INC.
William McCrann, President

MARK SECURITIES, INC.
Robert Roth, President

FRANKLIN PLANNING CORPORATION — 965
Frank Rozanski, President

ZENITH AMERICAN SECURITIES CORPORATION
Samuel Ballin, Senior Vice President

FAMILY, INDUSTRY & COLLEGE PLANNING CO., INC.
William Margeson, President

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FEBRUARY 28 -- New York Stock Exchange Member Firms

NATIONAL MUTUAL FUND MANAGERS ASSOCIATION 1022
Bradley Baker, President
Robert McCollester, Vice President
George Washburn, Vice President
Manuel Glassman, Member of Executive Committee

MARCH 13

T. ROWE PRICE COMPANY 1164
William Thompson, Vice President & Director

F. EBERSTADT & COMPANY
Dr. Robert Perez, Vice President

DREYFUS CORPORATION
David Burke, Vice President

LEAGUE INVESTMENT DISTRIBUTORS COMPANY
Henry Satchwell, President

MARCH 14

J & H EQUITY CORPORATION 1381
Paul Gartland, President

SIDE,FUND, INC.
Richard Bassuk, Chairman of the Board

KEYSTONE CUSTODIAN FUNDS, INC.
Franklin Johnson, Senior Vice President

CAPITAL RESEARCH & MANAGEMENT COMPANY
Robert Cody, Senior Vice President

INVESTMENT COMPANY INSTITUTE
Robert Augenblick, President

PRUDENTIAL INSURANCE COMPANY OF AMERICA
Allen Thaler, Senior Vice President

MARCH 15 -- Insurance Industry

AMERICAN LIFE INSURANCE ASSOCIATION 1507
Paul Mason, General Counsel
Robert J. Routier, Assistant General Counsel

AETNA VARIABLE ANNUITY LIFE INSURANCE COMPANY 1581
Arthur Blakeslee, III, President

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MARCH 16 -- Performance

EMPIRE PLANNING CORPORATION — 1624
Gerald S. Jeremias, President

LIPPER ANALYTICAL SERVICES — 1631
A. Michael Lipper, President

DAVID L. BABSON & COMPANY — 1638
David Babson, President

WIESENBERGER SERVICES — 1649
Paul Johnston, Vice President

WELLINGTON MANAGEMENT COMPANY — 1651
John Bogle, President

MARCH 19 -- Value of Services

SUPERVISED INVESTORS SERVICES, INC. — 1820
Thomas Anderson, Vice President

WELLINGTON MANAGEMENT COMPANY
John Bogle, President

FOSTER ASSOCIATES, INC.
Stephen Sherwin, Vice President

WADDELL AND REED, INC.
Raymond Grant, Senior Vice President and General Counsel

AETNA LIFE & CASUALTY COMPANY
George Gingold, Counsel

UNION SERVICE DISTRIBUTOR, INC.
H. Bridgman Griswold, President

MARCH 21

U.S. DEPARTMENT OF JUSTICE — 2019
Barry Grossman, Chief, Evaluation Section
Antitrust Division and
Daniel Hunter, Esquire

CHANNING MANAGEMENT CORPORATION — 2120
Carl Frischling, Senior Vice President

LIPPER ANALYTICAL SERVICES
A. Michael Lipper, President

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MARCH 21 cont.

NATIONAL SECURITIES & RESEARCH CORPORATION 2120
Phillip C. Smith, Chairman of the Board

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1186

Dr. Donald Farrar, Economist

SECURITY MANAGEMENT COMPANY
Everett Gille, President

UNION SERVICE DISTRIBUTORS
H. Bridgman Griswold, President

INVESTORS DIVERSIFIED SERVICES
Robert Loeffler, Senior Vice President

MARCH 28

WIESENBERGER SERVICES 2360
Donald Pitti, President

LORD, ABBETT & COMPANY 2366
Kenneth Cutler, House Counsel

INVESTORS DIVERSIFIED SERVICES 2374
Robert Loeffler, Senior Vice President-Law

CAPITAL RESEARCH GROUP 2385
James Fullerton, Senior Vice President & Director

OPPENHEIMER MANAGEMENT CORPORATION 2381
Donald Spiro, President