

at assembling portfolios which represent a broad cross section of the economy as a whole, while some are "specialty" funds which limit themselves to a particular industry or industries.<sup>86</sup>

The objectives of most funds are stated in rather general terms. They set forth the fund's primary emphases and basic policies but leave wide scope for managerial discretion. In selecting and supervising its portfolio, the fund strives for the best possible investment performance consistent with its objectives. To do so it needs security analysts and investment managers.

Most mutual funds do not hire employees of their own to provide these managerial skills. They obtain them from a separate entity called an "investment adviser." The fund pays the adviser an "advisory" fee which is almost always a percentage of the fund's net assets. The customary advisory fee of one-half of 1 percent of the fund's average net assets during the year<sup>87</sup> is the fund's principal operating expense.<sup>88</sup> A number of funds now have fee schedules under which the traditional one-half of 1 percent rate remains in effect up to a stipulated asset level with lower percentages applicable to that portion of the assets above the specified level.<sup>89</sup>

The investment adviser, which usually has organized and remains closely affiliated with the fund, is almost always more than a passive adviser; it selects the fund's portfolio and operates or supervises most other aspects of its business. Although the fund itself has a board of directors<sup>90</sup> and one or more executive officers, a substantial portion of the fund's directors<sup>91</sup> and all, or virtually all, of its officers will normally be associated with or employed by its advisers. In most cases all of the compensation that such persons receive for their services to the fund is paid to them by the adviser, not by the fund.

With rare exceptions, most advisers also supply the mutual funds that they manage with office space and with the clerical and accounting personnel necessary to carry on the fund's business. In most—but not in all—cases such services are paid for by the basic advisory fee.<sup>92</sup>

A mutual fund investment adviser can be an individual, but most advisers are partnerships or corporations. The securities of about 20 fund advisers are now publicly held.<sup>93</sup> Although many of the advisers to the large funds have no nonfund clients, a substantial number combine their mutual fund activities with a general investment counseling and/or securities business. For example, Lehman Bros., a prominent New York Stock Exchange member firm, was the founder

<sup>86</sup> See note 53, p. 40, supra.

<sup>87</sup> The fee is usually based on average daily net assets.

<sup>88</sup> The advisory fees, of course, a much higher percentage of a fund's income than it is of its capital.

<sup>89</sup> For example, a fund may pay an advisory fee at the annual rate of 0.50 percent on its first \$300 million of net assets, 0.40 percent on the next \$200 million and 0.30 percent on the net assets in excess of \$500 million.

<sup>90</sup> If organized as a trust, it will have a trustee or board of trustees instead of a board of directors.

<sup>91</sup> For the provisions of the Act which affect the composition of an investment company's board of directors, see pp. 67-68, *infra*.

<sup>92</sup> Mutual funds also require and usually pay directly for legal and auditing services as well as the services of custodians for their portfolio securities. In addition, they appoint stock transfer agents for the issuance and redemption of their securities and agents to disburse dividend and capital gain distributions to their shareholders. A bank almost always serves as custodian, and although banks frequently serve as stock transfer and disbursing agents, the investment advisers to some funds have themselves undertaken to furnish these services to the funds under their management. The funds usually pay the banks directly for any services provided by them, while in most, but not all, instances the investment advisory fee pays for all the nonadvisory services provided by the investment adviser.

<sup>93</sup> Sometimes the adviser is a subsidiary of a conglomerate company for whom mutual fund management is one of a number of activities. For example, International Telephone & Telegraph Corp. controls Hamilton Management Corp. which acts as investment adviser for Hamilton Funds, Inc. (approximate June 30, 1966, assets \$489 million). And Gates Rubber Co. controls Financial Programs, Inc., adviser to Financial Industrial Fund, Inc., and Financial Industrial Income Fund, Inc. (combined approximate June 30, 1966, assets \$347 million). A number of corporations not previously associated with the securities business or the investment company industry have from time to time contemplated the acquisition of existing or the launching of new mutual fund management companies.

of, is adviser to, and acts as regular portfolio broker for the One William Street Fund, Inc., a \$232 million mutual fund, and the Lehman Corp., a \$439 million closed-end investment company.<sup>94</sup> In addition to its investment company activities, Lehman Bros. has an extensive non-fund investment advisory and general securities brokerage clientele, is a leading underwriter of securities and acts as financial adviser to many large corporations.<sup>95</sup>

3. *Fund complexes*

Many mutual fund advisers organize and manage a number of funds which have different types of investment policies. Thus, the same adviser may manage a balanced fund, a common stock fund stressing possible capital appreciation, and another fund stressing current income. Such groups of funds under common management are sometimes referred to as "fund complexes."

The largest fund complex is managed by Investors Diversified Services, Inc. ("IDS") and consists of:

- (1) Investors Mutual, Inc., a balanced fund with net assets of \$2.84 billion;
- (2) Investors Stock Fund, Inc., a common stock fund with net assets of \$1.73 billion;
- (3) Investors Variable Payment Fund, Inc., a \$560 million common stock fund with emphasis on those stocks offering possibilities of capital appreciation;<sup>96</sup> and
- (4) Investors Selective Fund, Inc., a bond and preferred stock fund with net assets of \$44 million.<sup>97</sup>

In a few instances the funds in the complex are registered under the Act as a single investment company issuing shares in separate series. Each such series has a separate portfolio; all of the portfolios are managed by the same adviser, but each is administered in accordance with a separate investment policy. United Funds, Inc., a single registered investment company, with assets of about \$2.2 billion on June 30, 1966, is an example of the single company type of fund complex. This company has four different portfolios: (1) a growth-oriented common stock fund, (2) an income-oriented fund, (3) a science fund stressing securities of issuers involved in new technological developments, and (4) a bond fund. In the single company type of complex, the investor who buys shares of a particular series obtains only an interest in the portfolio maintained for that series and is unaffected by the performance of the other portfolios.

Fund complexes enable a mutual fund adviser to reach a broader cross section of potential investors and to offer each investor the opportunity to apportion his aggregate mutual fund investment among several funds with different investment objectives all managed by the same adviser. Most shareholders of a mutual fund that belongs to a

<sup>94</sup> Figures for both companies are as of June 30, 1966.

<sup>95</sup> Among the other prominent New York Stock Exchange member firms that have organized and thereafter acted as investment advisers to investment companies are Lazard Freres & Co., founder of and adviser to the Lazard Fund, Inc. (assets approximately \$92 million as of June 30, 1966) and F. Eberstadt & Co., founder of and adviser to Chemical Fund, Inc. (assets approximately \$437 million as of June 30, 1966). Other New York Stock Exchange firms active in the investment company business are referred to in note 159 on p. 59, *infra*. See also pp. 50, 109, *infra*, for a discussion of the relationship between the New York Stock Exchange firm of Dreyfus & Co. and the Dreyfus Fund, Inc., the largest of the broker-affiliated investment companies with assets of about \$1.5 billion on June 30, 1966.

<sup>96</sup> Investors Intercontinental Fund, Inc., a common stock fund investing mainly in the securities of foreign issuers was merged into Investors Variable Payment Fund, Inc., on May 16, 1966.

<sup>97</sup> Asset figures for the IDS funds are as of June 30, 1966. In addition, IDS is the dominant factor in the face-amount certificate business (see note 37 on p. 38, *supra*).

complex have the option to switch to other funds within the same complex at a reduced sales load, no sales Load, or upon payment of a minimal transfer charge.<sup>98</sup>

Table 11-3 identifies the constituent companies and gives the assets (as of June 30, 1966) of the 10 largest fund complexes. The 52 funds in these 10 complexes held 55 percent of all mutual fund assets on June 30, 1966, and about 45 percent of all investment company assets as of that date.

TABLE 11-3.—The 10 largest fund complexes as of June 30, 1966

| Investment adviser and names of companies in complex  | Aggregate net assets of complex (millions) |
|---|--|
| (b) Massachusetts Investors Trust.....  | 3,019.9                                    |
| 3. Fidelity Management and Research Co.:  |  |
| (a) Government Fund, Inc. ....  |  |
| (b) Fidelity Investment Fund, Inc. ....   |  |
| (d) Essex Fund, Inc. ....   |  |
| (e) Everest Income Fund, Inc. ....  |  |
| (f) Fidelity Capital Fund, Inc. ....  |  |
| (g) Fidelity Fund, III .....  | 2,678.3                                    |
| (h) Fidelity Trend Fund, Inc. ....  |  |
| (j) Memphis & County Medical Society, -IC. Investment Retirement Trust .....  |  |
| (k) Puritan Fund, Inc. ....   |  |
| (l) Second Congress Street Fund, Inc. ....  |  |
|   | 2,239.2                                    |
| (d) United Income Fund .....  |  |
| (e) United Science Fund .....   |  |
| 5. Wellington Management Co.:   |  |
| (a) Exeter Fund, Inc. ....  |  |
| (b) Wellington Fund, Inc. ....  |  |
| (c) Windsor Fund, Inc. ....   | 2,050.4                                    |
| 6. Investors Management Co., Inc.:  |  |
| (a) Diversified Investment Fund, Inc. ....  |  |
| (b) Environmental Investors, Inc. ....  |  |
| (c) Westminster Fund, Inc. ....   | 1,581.1                                    |
| 7. None, common internal management (investment advice and administrative services furnished at Sunbelt Investing Corp. which is owned by the 4 companies): |  |
| (a) National Sunbelt Investing Corp. ....   |  |
| (c) Tri-Continental Corp. ....  | 1,439.9                                    |
| (d) Whitehall Fund, Inc. ....   |  |
| 8. Lord Abbett & GO.:   |  |
| (a) Affiliated Fund, Inc. ....  |  |
| (b) American Business Shares, Inc. ....   | 1,282.3                                    |
| a   | owned                                      |

b See p. 49, infra.  
 c Managed by N  
 d by

TABLE II-3.—The 10 largest fund complexes as of June 30, 1966—Continued

| Investment adviser and names of companies in complex                   | Aggregate net assets of complex (millions) |
|--|--|
| 9. Keystone Custodian Funds, Inc.:                                     |  |
| (a) Constitution Exchange Fund, Inc. ....                              | } \$1,194.4                                |
| (b) Investors Capital Exchange Fund .....                              |  |
| (c) Keystone Custodian Fund B-1 (investment bond fund) .....           |  |
| (d) Keystone Custodian Fund B-2 (medium grade bond fund) .....         |  |
| (e) Keystone Custodian Fund B-3 (low-priced bond fund) .....           |  |
| (f) Keystone Custodian Fund B-4 (discount bond fund) .....             |  |
| (g) Keystone Custodian Fund K-1 (income fund) .....                    |  |
| (h) Keystone Custodian Fund K-2 (growth fund) .....                    |  |
| (i) Keystone Custodian Fund S-1 (high-grade common stock fund) .....   |  |
| (j) Keystone Custodian Fund S-2 (income common stock fund) .....       |  |
| (k) Keystone Custodian Fund S-3 (growth common stock fund) .....       |  |
| (l) Keystone Custodian Fund S-4 (lower priced common stock fund) ..... |  |
| (m) Keystone International Fund, Inc. ....                             |  |
| 10. The Putnam Management Co., Inc.:                                   |  |
| (a) The George Putnam Fund of Boston .....                             | } 1,193.3                                  |
| (b) Putnam Investors Fund, Inc. ....                                   |  |
| (c) The Putnam Growth Fund .....                                       |  |
| (d) The Putnam Income Fund .....                                       |  |
| Total .....  | 21,851.3                                   |

4. The internally managed funds

A few funds are managed in the conventional corporate manner by their own officers and directors or trustees. The largest of the so-called internally managed funds are Massachusetts Investors Trust ("MIT"), the second largest mutual fund, with assets of almost \$2.1 billion, and Massachusetts Investors Growth Stock Fund, Inc. ("MIG"), the 10th largest fund, with assets of almost \$931 million.<sup>99</sup> MIT, a trust, is managed by a board of five trustees. The MIT trustees also serve, together with various other persons, as directors of MIGS, a corporation.<sup>100</sup>

The funds obtain investment advice and other management services from MIT's own employees who are compensated by fixed salaries paid to them by MIT.<sup>101</sup> Although the formulas under which the MIT trustees are compensated place them among the best-paid executives in American industry,<sup>102</sup> and although MIT must bear costs that would be borne by its adviser were it an externally managed fund, MIT's expenses per dollar of assets managed are substantially lower than those of any of the externally managed funds listed in table II-2 at page 35, supra.<sup>103</sup>

5. The prevalence of external management

Internally managed funds are an exception to the general industry pattern. The practice of buying investment advice and management from an external adviser is one of long standing and was firmly imbedded in the industry at the time that the act was under consideration. The Act permitted it to continue. It seems to stem from the fact that many of the early open-end companies were started by investment counselors who viewed the companies as their alter egos

<sup>99</sup> Asset figures for both funds are as of June 30, 1966.

<sup>100</sup> The 12-man MIGS board includes seven persons who are not trustees of MIT.

<sup>101</sup> MIGS bears a portion of the expenses involved.

<sup>102</sup> MIT pays its trustees an annual fee consisting of a percentage of the fund's average net assets and gross earnings (excluding capital gains and losses). See pp. 105-106, infra.

<sup>103</sup> In fiscal 1965 MIT's expense ratio was 0.18 percent while MIGS' expense ratio was 0.38 percent. MIGS' expense ratio is substantially higher than that of MIT because the MIT trustees are compensated under a different formula for their services to MIGS. See pp. 105-106, infra.

and not as business enterprises capable of existing independently of their sponsors.<sup>104</sup> In many instances the fund was formed because the adviser believed that it was difficult or impossible to provide adequate advisory services for clients of modest means without some sort of a pooling arrangement that would permit such clients to benefit from broad portfolio diversification and professional management. This consideration is still a factor in the mutual fund business.<sup>105</sup>

Moreover, the mutual funds of that era were small and might have been unable to bear the cost of advisory establishments comparable to those maintained by their advisers. There still are many funds that may have to resort to outside advisers because of their limited resources.<sup>106</sup> But external management remains predominant even in the case of the largest funds whose resources are clearly large enough to permit them to establish efficient, well-staffed and well-remunerated advisory departments of their own.<sup>107</sup>

The advice and the managerial services that the adviser supplies go to the heart of the investment company business. It would be a mere duplication for the fund to establish a staff of its own to do the work that the adviser's staff is already doing. Moreover, the growth that makes it economically feasible for a fund to support a staff of its own makes the advisory contract increasingly profitable to the adviser-manager. Hence—no matter how large the fund grows—the adviser has no incentive to recommend the establishment of an internal management that might make the advisory contract superfluous.

#### 6. *Portfolio transactions*

Mutual funds are constantly buying and selling large blocks of securities. Since these purchases and sales are almost always made through brokers, the funds have a substantial volume of brokerage business to allocate among competing brokers. The distribution of this business is almost always under the control of the fund's adviser. If the adviser is itself a broker or an affiliate of a brokerage house, it or its brokerage affiliate will normally receive much of the fund's brokerage business. For example, the New York Stock Exchange firm of Dreyfus & Co. received approximately \$2.3 million in brokerage commissions from the Dreyfus Fund, Inc., during 1964, when the Dreyfus Corp., the fund's investment adviser, was a wholly owned affiliate of the brokerage firm.<sup>108</sup>

Advisers unaffiliated with brokerage firms usually apportion the brokerage business of the fund or funds under their control among a number of brokers. Brokers often obtain fund brokerage business in exchange for such services as investment research and statistical information, daily quotation service for the purpose of computing the net asset value of the fund's shares, and direct telephone lines.<sup>109</sup> However, most advisers use much of the brokerage business they control to

<sup>104</sup> See Investment Trust Study, Pt. 2, 57.

<sup>105</sup> See pp. 58-59, *infra* with respect to the relationship between the fund and the nonfund activities of certain investment advisers. Also pertinent is the sponsorship of investment companies by commercial banks. See pp. 35-57, *supra*. Such companies enable the banks to broaden the range of the clientele served by their traditional investment advisory services.

<sup>106</sup> However, a small fund may be a member of a large complex of funds with aggregate resources large enough to permit the maintenance of an adequate internal advisory staff serving the entire group of funds.

<sup>107</sup> On the other hand, the large closed-end companies are usually managed internally along conventional corporate lines by their own officers and employees.

<sup>108</sup> In October of 1965 the partners in the brokerage firm sold almost all of their stock in the adviser to the public. However, Dreyfus & Co. remains the Dreyfus Fund's regular portfolio broker.

<sup>109</sup> See Wharton Report 527. If the advisers were unable to pay for these services with the funds' brokerage business, they or the funds would have to pay for them in cash.

reward brokers and dealers who sell the funds' shares.<sup>110</sup> A brokerage firm that sells mutual fund shares normally gets a share of the fund's brokerage commissions as extra compensation for its sales efforts. Hence the funds' brokerage business has become a source of additional selling compensation for retail distributors of fund shares.<sup>111</sup>

The use of portfolio brokerage business to reward brokers who sell fund shares is facilitated by the rules and the commission rate structures of the various exchanges. These rules require all customers to pay minimum commissions. But the broker who actually executes a transaction can give some of his commission to other brokers. Such commission splitting is permissible under exchange rules even if the other brokers do no work in connection with the transaction. Hence one portfolio purchase or sale can be used to produce income for several brokers by having the broker to whom the order is given divide his commission with a number of other brokers.<sup>112</sup> This allows the funds' investment advisers to channel the funds' exchange transactions to a relatively small number of brokers and at the same time to distribute supplemental cash payments derived from the brokerage commissions paid on those transactions to the much larger number of dealers who sell fund shares.<sup>113</sup> If a transaction is executed on the New York Stock Exchange, the commission can be shared directly only by members of that exchange.<sup>114</sup> However, fund advisers can direct brokerage dollars to broker-dealers that are not New York Stock Exchange members by instructing their brokers to execute transactions on a regional exchange of which the dealer that they wish to benefit is a member.<sup>115</sup> Further, by using those regional exchanges which permit their members to share commissions with broker-dealers who are not members of any exchange, advisers can direct portions of the brokerage income created by fund activities to over-the-counter securities firms that sell fund shares.

### 7. Selling new shares

As has been pointed out, the shares of a vast majority of mutual funds are continuously sold to investors.<sup>116</sup> Some funds sell their shares at net asset value without the imposition of a sales charge. Most funds, however, add a charge to net asset value known as the "sales load."<sup>117</sup> Such funds are called "load funds," while those whose shares are sold at net asset value are called "no-load funds."<sup>118</sup>

<sup>110</sup> This is not true in the case of funds whose shares are distributed by the principal underwriter's own retail selling organization. See p. 56, *infra*.

<sup>111</sup> See Special Study, pt. 4, 215-218. Where the fund's adviser-underwriter keeps most or all of its brokerage business for itself, it may have to give almost all of the salesload to its retail dealers in order to offset the competitive disadvantage flowing from its failure to direct brokerage business to members of its dealer group.

<sup>112</sup> The nonexecuting brokers usually receive 60 percent of the aggregate commission. The executing broker finds it worth his while to accept fund business for 40 percent of the normal brokerage fee.

<sup>113</sup> Brokerage compensation (in the form of markups or commissions) derived from over-the-counter transactions cannot properly be used to reward dealers who have no bona fide connection with the transaction, since there are no minimum schedules of charges in the over-the-counter market. See pp. 178-179 *infra*.

<sup>114</sup> New York Stock Exchange Constitution, art. XV.

<sup>115</sup> Many securities listed on the New York Stock Exchange are also listed on regional exchanges, and many of the large New York Stock Exchange firms that act as brokers for the funds also belong to one or more regional exchanges.

<sup>116</sup> See pp. 42-43, *supra*.

<sup>117</sup> This term is used in the Act (Secs. 2(a)(34), 10(d)(3), 22(b)) as well as by the industry.

<sup>118</sup> Although the Act makes no express use of the terms "load fund" and "no-load fund," it recognizes the existence of and makes provision for the two types. Thus, sec. 10(a) of the Act requires that at least 40 percent of the directors of a registered investment company consist of persons otherwise unaffiliated with the company, while sec. 10(d) allows no-load funds to have, under specified conditions, only one unaffiliated director. See pp. 67-68, *infra*, for a discussion of the statutory concept of "affiliation."

Most mutual fund investors pay a sales load in connection with the purchase of their shares. On June 30, 1966, total mutual fund assets amounted to about \$38.2 billion. Only \$2.1 billion<sup>119</sup> or a little over one-twentieth of that amount was held by the approximately 60 no-load funds registered with the Commission on that date.<sup>120</sup> In terms of shareholder accounts, at the end of 1965 the 10 largest no-load funds had a total of about 209,000 shareholder accounts,<sup>121</sup> roughly one-thirteenth as many as the approximately 2,686,000 shareholder accounts of the 10 largest load funds.<sup>122</sup>

### 8. The load funds

A person who invests in a load fund does not obtain an interest in the fund equal in value to the amount that he pays for his shares, since the sales load is first deducted from the purchase price.<sup>123</sup> The sales load does not go to the fund but to a separate selling organization.<sup>124</sup> The load is a stipulated percentage of the total purchase price. The amount of the load varies to some extent from fund to fund, but almost always ranges from 7.50 to 8.75 percent of the total purchase price, with 8.50 percent found most often at present. Most funds charge lower loads on larger purchases, but a reduction in the basic load is seldom made for a purchase of less than \$10,000. The following schedule is considered representative:

#### Sales load (as a percentage of the total purchase price)

|                        |      |
|------------------------|------|
| Size of purchase: *    |      |
| Less than \$12,500     | 8.50 |
| \$12,500 to \$24,999   | 7.50 |
| \$25,000 to \$49,999   | 5.75 |
| \$50,000 to \$99,999   | 4.00 |
| \$100,000 to \$249,999 | 3.25 |
| \$250,000 to \$999,999 | 2.50 |
| \$1,000,000 and over   | 1.00 |

\* The levels at which the charges fall (\$12,500, \$25,000, \$50,000, etc.) are called "breakpoints."

The imposition of an 8.50 percent load means that a load fund receives \$915 from an investor who expends \$1,000. to purchase its shares. If the investor later redeems his shares, and if there has been no change in the market prices of the fund's portfolio securities, the fund cannot possibly pay him more than the \$915 that it received. In fact, the investor will probably receive a little less than \$915.

<sup>119</sup> Includes \$231 million held by the One William Street Fund, Inc., which was a load fund from the time of its organization in 1958 until June 20, 1964, when it became a no-load fund. The One William Street Fund, Inc. was the largest no-load fund on June 30, 1966, and is now the second largest of the no-load funds.

<sup>120</sup> This is about the same amount as the assets held on that date by the diversified closed-end companies. See p. 44, supra. However, since the closed-end companies, as a group, are older than the no-load funds, unrealized appreciation rather than new capital accounts for a larger proportion of the closed-end companies' total assets than of the no-load funds' total assets.

<sup>121</sup> Includes approximately 60,000 shareholders of the One William Street Fund, Inc. See footnote 119 on this page.

<sup>122</sup> This is identical with the figure previously given for the aggregate number of shareholder accounts in the 10 largest diversified companies (p. 41 supra) because all of those companies, which are listed in table 11-2 at p. 45, supra, are load funds. The largest no-load fund, T. Rowe Price Growth Stock Fund, Inc., with about \$224.1 million in assets on June 30, 1966, and about 42,000 shareholders on Dec. 31, 1965, is not large enough to be placed among the largest open-end companies.

<sup>123</sup> The Act defines "sales load" 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 trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities." Sec. 2(a)(34)

<sup>124</sup> Cases in which the fund itself exacts and retains a sales charge are uncommon. In these instances, the charge is much lower than in the typical load fund. Moreover, the marketing techniques of the funds that retain purchasers' sales charges are more akin to those of the no-load funds than to those of the typical load fund. Accordingly, the funds that charge a sales load which they retain for themselves have been treated as no-load funds for the purpose of this report. At present, the largest fund of this type whose shares are available to the general public is Growth Industry Shares, Inc., with assets of about \$41.7 million on June 30, 1966.

This is so because injections of new capital into and withdrawals of old capital from a mutual fund lead to purchases and sales of portfolio securities that entail brokerage costs. These brokerage costs are charged to capital, not to income. Accordingly, our hypothetical investor's \$915 will be reduced by portfolio brokerage costs. The amount of these brokerage costs depends on the extent of the gap between sales and redemptions and on the fund's cash position.<sup>125</sup> The \$85 sales charge is retained by those who did the selling.

The practice of expressing the mutual fund sales load as a percentage of the total purchase price differs from the way in which sales charges are computed in transactions on the organized securities exchanges and in the over-the-counter securities markets. There, brokerage commissions are expressed as a percentage of the amount paid by the buyer to the seller, not as a percentage of the total cost of acquisition. And in those over-the-counter securities transactions in which the securities dealer acts as principal rather than as agent, the dealer's markup is a percentage of the contemporaneous cost of the securities to the dealer, not of their cost to the investor. Mutual fund sales loads appear about one-tenth higher when expressed as a percentage of the amount of the purchaser's money actually received by the fund. The \$85 sales load on a \$1,000 purchase of mutual fund shares from which an 8.5 percent load is deducted is 9.3 percent of the \$915 that actually goes to the fund and would be described as a 9.3 percent charge, instead of an 8.5 percent charge, if mutual fund sales loads were computed in the way in which selling commissions and discounts are usually computed in the exchange and over-the-counter markets.<sup>126</sup>

From the small investor's point of view the sales load is by far the principal cost of a mutual funds investment.<sup>127</sup> Most mutual fund investors are small investors,<sup>128</sup> and the 8.5 percent sales load that they normally pay is—assuming that the net asset value of the fund's shares does not change—almost 19 times their pro rata share of the customary annual advisory fee of one-half of 1 percent.<sup>129</sup>

The load is also higher than the cost of acquiring most other types of securities. Most mutual fund portfolios consist, in the main, of

<sup>125</sup> See 205, *infra*.

<sup>126</sup> Underwriting commissions and discounts with respect to the sale of conventional newly issued or outstanding securities being offered to the general public for the first time are computed in the same fashion as that in which mutual fund sales loads are computed, i.e., as a percentage of the total purchase price. The distribution of conventional securities of this sort differs, however, in a number of respects from the distribution of mutual fund shares. See p. 55, *infra*.

<sup>127</sup> Large investors benefit from the reduced loads charged for substantial purchases. See p. 52, *supra*.

<sup>128</sup> The survey of mutual fund purchasers made for the Special Study by the Wharton School's Securities Research Unit concluded that: "A profile of the typical mutual fund purchaser\* can be sketched roughly as follows: He is a man in his middle to late forties, who is married, and has about three dependents. His formal education probably stopped after high school graduation; but there is a fair chance that he has done a small amount of college work. Moreover, he is employed most likely in a capacity involving specialized skills—but somewhat short of formal professional training. His annual income falls in the \$5,000 to \$10,000 range. Chances are 9 in 10 that he is covered by life insurance, the median amount being between \$10,000 and \$15,000." Special Study, pt. 4, 273.

The survey on which the foregoing conclusions were based was made in September and October of 1962. Subsequent surveys by the Investment Company Institute show a considerable rise in the income of mutual fund shareholders between 1963 and 1966. See Investment Company News, June 1966 (1966 median family income of mutual fund shareholders who purchased their shares on a lump sum basis was \$11,350 as against a comparable figure of \$8,122 in 1963, and 1966 median family income of mutual fund shareholders who are accumulating mutual fund shares pursuant to installment plans (see pp. 57-58, *infra*) was \$11,750 as against \$9,045 in 1963. Of course, since these figures are medians one-half of the persons in the groups surveyed had family incomes below the medians. Moreover, the Investment Company Institute reports that its data show that the portion of an investor's total assets represented by mutual fund shares "does vary by income, with fund holdings diminishing as income increases" (Investment Company News, June 1966, p. 2). (Emphasis added.) (See also pp. 205-207, *infra*.)

<sup>129</sup> In the case of the \$1,000 mutual fund investment at an 8.5 percent load, the load is \$85. If there is no change in the net asset value of the fund's shares during the year subsequent to the making of the investment the pro rata share of the annual advisory fee will be about \$4.57, roughly one-half of 1 percent of the amount actually at work in the fund.



issues listed on national securities exchanges.<sup>130</sup> Since the cost of purchasing a round lot<sup>131</sup> of a listed security,<sup>132</sup> which is usually around 1 percent of the purchase price, must be paid by sellers as well as by buyers, the total cost of the purchase and subsequent sale of a listed security, assuming no change in the security's market price, is normally about 2 percent (1 percent when buying and a second 1 percent when selling) of the security's price. Load fund shares, on the other hand, can be converted into cash free of charge.<sup>133</sup> Nevertheless, the 9.3 percent charge that the usual load fund shareholder pays at the time of acquisition is more than four and one-half times the aggregate 2 percent charge incurred by the usual buyer of a conventional listed security who subsequently decides to sell.<sup>134</sup> This marked difference in sales charges becomes even more striking when one remembers that the load funds themselves pay brokerage commissions when they buy and sell securities, just as other investors do, and that the burden of those brokerage commissions falls on their shareholders. Thus the sales load can to some extent be viewed as an addition to, rather than as a substitute for, the sales charges that an investor has to pay when he invests directly for his own account.<sup>135</sup> This higher cost of purchasing load fund shares is attributable in large measure to the method by which those shares are sold.

### 9. How load fund shares are sold

The sale of new load fund shares is always contracted out to an external organization which has the exclusive right to obtain shares from the fund and sell them to dealers or to the public or both. In most cases, this exclusive right is given to either the investment adviser itself or a separate organization owned by, or closely affiliated with, the adviser.

Since mutual fund shares are securities, and since those who distribute new securities on behalf of issuers are called underwriters, the holder of this exclusive right is known as the fund's "principal underwriter."<sup>136</sup> The underwriting of mutual fund shares is quite different, however, from the underwriting of conventional securities. An underwriter of a new issue of conventional securities is concerned with

<sup>130</sup> See Wharton Report 182-191 (listed issues accounted for over 85 percent of the aggregate money value of funds' stockholdings).

<sup>131</sup> A round lot usually consists of 100 shares or a multiple thereof.

<sup>132</sup> The shares of most of the larger diversified closed-end companies, which also offer diversification and professional investment management, are listed on securities exchanges.

<sup>133</sup> Although a number of load funds are authorized by their charters to impose redemption fees, few of them actually charge a redemption fee at the present time.

<sup>134</sup> A number of load funds—some of them quite large—invest largely or even exclusively in over-the-counter securities. To purchasers of shares in such funds a comparison of load fund acquisition costs to over-the-counter acquisition costs is meaningful. Charges for executing transactions in the over-the-counter are governed by the rules of the National Association of Securities Dealers, Inc. (NASD). See pp. 62-63, *infra*, for a description of the functions of this organization and its impact on the distribution of securities. The NASD's rules generally require that such charges be fair and reasonable taking into consideration all relevant circumstances. A substantial portion of over-the-counter transactions are executed on an agency basis. In these instances a commission—usually comparable to the commissions for executing exchange transactions—is charged (Special Study, pt. 2, 612-614). With respect to transactions executed on a principal basis, the NASD's markup policy generally provides that a pattern of markups exceeding 5 percent of the dealer's contemporaneous cost is excessive unless justified by special circumstances. The NASD's statement notes however, that "[a] markup pattern of 5 percent or even less may be considered unfair or unreasonable: and that if a customer uses the proceeds from the sale of a security to purchase another security through the same broker-dealer, an extra charge for executing the sale cannot be made. (NASD Manual G-1 to G-6.) In fact, the markups in most over-the-counter transactions, particularly those in the higher priced, more actively traded issues, are less than 5 percent. There higher priced, more actively traded issues usually figure prominently in the Over-the-counter component of a mutual fund's portfolio. Moreover, this is the type of issue in which most mutual fund purchasers would be likely to invest were they to purchase over-the-counter securities for their own account. Hence the aggregate cost of a purchase and a subsequent sale of an over-the-counter security will—as a general rule—be considerably lower than the normal mutual fund sales charge of 9.3 percent. See pp. 211-212, *infra*.

<sup>135</sup> See p. 53, *supra*, and pp. 205-207, *infra*.

<sup>136</sup> Act sec. 2(a)(28). Although a load fund could have a number of principal underwriters, the use of only one principal underwriter is customary.

raising a specific amount of money within a limited time by selling a stated quantity of securities to the public.<sup>137</sup> Its relationship to the issuer whose securities it is selling is not continuous but is limited to a specific offering. Its compensation consists wholly or largely of the difference between the amount it receives from the public and the amount it is obligated to turn over to the issuer.<sup>138</sup>

The principal underwriter of a mutual fund, on the other hand, has a much broader and a continuing function. Its function is not to sell a specific quantity of securities within a stated time, but to channel as great a *continuous* flow of new capital into the fund as it possibly can. Since in most instances the principal underwriter is also the investment adviser or closely affiliated with the adviser, the economic benefits derived from the discharge of the underwriting function are not limited to underwriting compensation as such. Growth in the size of the fund which results from new share sales outpacing redemptions increases the annual advisory fee. When the adviser or its affiliate serves as regular broker to the fund, growth through the sale of new fund shares leads to an increase in the brokerage commissions paid to the adviser-broker. Thus, sales of new shares that generate increases in continuous advisory income and brokerage payments may warrant the maintenance of an otherwise unprofitable underwriting operation.<sup>139</sup>

The principal underwriter is usually a wholesaler of the fund's shares. It leaves the retail selling to numerous retail dealers and usually attempts to bring as many retail dealers as it can into its dealer group. A principal underwriter for a large fund or group of funds may have a dealer group of hundreds of retail securities dealers who do the actual selling to the public. The retail dealer need not and normally does not bind himself to one principal underwriter but deals with a number of different principal underwriters and sells the shares of many different funds simultaneously.

The chief endeavor of a principal underwriter is twofold. First, it seeks to encourage retail dealers to sell mutual fund shares rather than other types of securities. Secondly, the principal underwriter tries to encourage retail dealers to sell the shares of the fund or funds that it is distributing rather than the shares of the funds underwritten by other principal underwriters. Hence the principal underwriter

<sup>137</sup> In many such underwritings the underwriter agrees to buy those securities from the issuer. In that event, he must supply the issuer with a stipulated amount of money on a certain date whether or not he has succeeded in inducing others to buy the issuer's securities from him. He is called an underwriter because he underwrites or assumes the risk that the securities will be unsalable to the public at the agreed upon offering price. The principal underwriter of a mutual fund takes no such risk. It does not undertake to sell a specific quantity of shares and is not obligated to pay the fund a stated sum of money. Its only obligation to the fund is that of using its best efforts to obtain orders for shares. It obtains shares from the fund only after it has first received an order for them. The sales aspect of the mutual fund business is to some extent analogous to "best efforts" distributions of conventional securities. In both cases the "underwriter" is really a selling agent rather than a risk bearer. But even a "best efforts" underwriter of a conventional security must usually dispose of a fixed quantity of securities within a limited time.

<sup>138</sup> The conventional underwriter sometimes receives noncash compensation; for example, Securities sold to it at prices less than their public offering price (or current fair market value), or long-term options or warrants to buy additional quantities of the underwritten security at prices close to the present public offering price. Since the underwriter usually pays a nominal price for such options or warrants, they offer an opportunity for capital appreciation—sometimes for very substantial capital appreciation—with little or no counterbalancing risk of loss. When underwriters receive such noncash compensation, they usually do so in connection with the distribution of unseasoned securities or those being offered to the public for the first time. The Act prohibits mutual funds from compensating their underwriters or other persons for that matter—in this fashion. See p. 68, *infra*. But this does not mean that such noncash compensation is unavailable to mutual fund underwriters. Although persons engaged in the distribution of mutual funds cannot receive securities at bargain prices or options or warrants from the funds themselves, they can—and do—receive such emoluments from the mutual fund management companies whose freedom to issue securities on such terms and conditions as they please is unrestricted by the Act.

<sup>139</sup> Advisory income often subsidizes unprofitable underwriting operations. See pp. 122-125, 201.

must make the sale of shares of its fund more advantageous to retail dealers than—or at the very least as advantageous as—the sale of shares of funds distributed by competing principal underwriters. One method of competing for the dealer's favor is to increase the direct sales compensation he receives. Another is to reward him with a portion of the brokerage commissions generated by the fund's purchases and sales of portfolio securities.

Some principal underwriters use a marketing technique quite different from the one that has just been described. They sell directly to the consumer through their own or their subsidiary's retail sales staff. The retailing employees of these integrated distributors are known as "captive sales forces." Among the integrated distributors is Investors Diversified services, Inc., investment adviser to and principal underwriter of the largest fund complex, with assets of almost \$5.2 billion as of June 30, 1966.<sup>140</sup> This adviser-underwriter's sales organization has several thousand salesmen and is the exclusive retailer of the four funds that it advises and underwrites and sells only the shares of those funds.<sup>141</sup>

Although most load fund shares are still sold through independent retail dealers in business for themselves, captive sales forces are of growing importance. The loads charged by funds whose shares are distributed by captive sales forces are about the same as those charged by the funds that use the conventional wholesaler-retailer system. Most of the load goes to the individual salesmen who make the sale and to the supervisory staffs who recruit, train, and stimulate the efforts of the salesmen.<sup>142</sup>

Competition for dealer interest among the principal underwriters who use the independent retailer system and competition for salesmen among the integrated principal underwriters has exerted an upward pressure on sales loads. Countervailing downward pressures have been weak or absent. The lack of effective downward pressure may be related to the fact that all of the dealers and all of the salesmen who sell shares of a particular fund do so at the same price. The Act specifically prohibits the sale of mutual fund shares at prices below the public offering price stated in the prospectus,<sup>143</sup> thus creating a sheltered, price-protected market for merchandisers of fund shares.<sup>144</sup>

A high level of direct selling compensation in a price-protected market,<sup>145</sup> coupled with the increased advisory fees and the augmented brokerage commissions that result from new sales, is a strong stimulus to vigorous, intensive, personalized selling effort. Load fund shares are usually sold by personal contact between a salesman and a prospect.<sup>146</sup> By searching out, meeting, talking to, counseling, and exerting direct personal influence on prospective investors, the load funds' salesmen have brought mutual fund shares to the attention and tapped the savings of millions of Americans, many of them not previously inclined to invest in equity securities.

<sup>140</sup> See table II-3 at p. 48, *supra*. In addition, Investors Diversified Services manages about \$1 billion that investors have placed in its face-amount certificates.

<sup>141</sup> One of those funds is Investors Mutual, Inc., the largest single fund with assets of more than \$2.8 billion as of June 30, 1966. See table II-2 at p. 45, *supra*.

<sup>142</sup> The supervisors are almost always compensated by "overriding" commissions on the sales of the salesmen they supervise. See Special Study, pt. 4, 147.

<sup>143</sup> Sec. 22(d).  
<sup>144</sup> The background and present utility of this resale price maintenance system are considered at pp. 218-223, *infra*.

<sup>145</sup> The principal underwriter retains only a small share of this direct selling compensation, most of which goes to the dealers and the salesmen who do the actual selling.

<sup>146</sup> See Special Study, pt. 4, 102-139.

10. *Selling load fund shares on the installment plan: Contractual plans and voluntary plans*

Many investors buy load fund shares on an installment basis by investing relatively small amounts of money at monthly or other regular intervals. The two ways of doing this systematically are known in the industry as the "contractual plan" and the "voluntary plan."

The contractual plan involves the purchase of a "periodic payment plan certificate" which evidences an indirect interest in the shares of a mutual fund.<sup>147</sup> Generally, the certificate is issued by a unit investment trust which is itself an investment company<sup>148</sup> with a portfolio consisting solely of the shares of a specific "underlying" mutual fund. The contractual plan's principal underwriter or "sponsor" may or may not be identical to or affiliated with the principal underwriter of the particular fund in which the proceeds of the payments received from the contractual planholders are invested.<sup>149</sup>

Contractual plan certificates provide for specified monthly payments over predetermined periods. Most common is the 10-year, 120-payment certificate.<sup>150</sup> Although termed "contractual," the plan imposes no binding legal obligation on the investor to make the payments. He is at liberty to miss payments or to cease them altogether. If the investor does so, dividends and capital gain distributions on underlying fund shares already paid for continue to be credited to his account. And he has the right to redeem his plan certificate for cash or for the underlying fund shares whenever he wishes.

The distinguishing, and by far the most important, feature of the contractual plan is its loading arrangements. The aggregate sales load paid by a contractual plan investor who completes his plan is the same as, or at most only slightly higher than, that paid by other purchasers of load fund shares.<sup>151</sup> Indeed, the Act imposes a 9 percent ceiling on contractual plan sales loads.<sup>152</sup> It is not the aggregate amount of the load but the schedule for deducting it that differentiates the contractual plan from the direct purchase of load fund shares. A large portion of the load charged with respect to the entire plan is deducted from the planholder's early payments. This feature, known as the "front-end load," is the hallmark of the contractual plan.

The Act expressly permits as much as one-half of the planholder's first 12 monthly payments, or their equivalent, to be deducted for sales load,<sup>153</sup> and almost all contractual plan sponsors deduct this legally permissible maximum from the investor's early payments. Since a major portion of the total sales load has been paid at the very outset of the plan, the sales load on installments after the first year is considerably less. Because of the front-end load, the contractual

<sup>147</sup> See Act secs. 2(a)(26), 27(a).

<sup>148</sup> See p. 38, *supra*.

<sup>149</sup> The indirectness of the contractual plan method of buying mutual fund shares does not subject the plan certificateholder to an additional investment advisory fee, since a unit investment trust has no investment adviser. Nor is there a double sales load. The unit trust pays no sales load when it buys the underlying fund's shares. Cf. rule 22d-1(f) under the Act (17 C.F.R. sec. 270.22d-1(f)). In addition, the underlying fund shares standing to the investor's credit on the sponsor's books are voted in accordance with the investor's instructions.

<sup>150</sup> The first payment must be at least \$20 and the subsequent monthly payments must be at least \$10. Act sec. 27(a)(4).

<sup>151</sup> The quantity discounts previously discussed in connection with the lump sum purchases (p. 52, *supra*) are also available to contractual plan investors who make large monthly payments. See p. 236, *infra*.

<sup>152</sup> See 27(a)(1). This is the only provision in any of the Federal securities statutes that imposes an express limit on sales compensation in the sale of equity securities.

<sup>153</sup> Sec. 27(a)(2).

plan is a high cost method of buying fund shares. Unless all or substantially all payments are completed, the total sales load will exceed 9 percent of total payments made. It may amount to as much as 50 percent of payments actually made. Secondly, the front-end load deduction causes even the contractual planholder who completes his payments on schedule to have substantially less money invested and working for him during most of the time prior to completion of the plan payments than he would have had if he had expended precisely the same sum that he spent on his contractual plan in the direct purchase from time to time of small quantities of mutual fund shares at level loads.

Persons of moderate means who wish to buy mutual fund shares on an installment basis need not expose themselves to the greater risk of loss and the lesser potential for gain and income attributable to the imposition of the front-end load in the sale of contractual plans. They can avail themselves of voluntary level-load plans. Voluntary level-load plans are simply a means of accumulating mutual fund shares through a series of monthly payments from each of which the fund's usual sales load is deducted. Unlike contractual plans, they involve only one investment company and only one security. Such plans, like contractual plans, generally provide for automatic investment of dividends and reinvestment of capital gain distributions in additional shares of the fund.<sup>154</sup>

Although from the investor's viewpoint the voluntary level-load plan is less expensive and entails less risk than the contractual plan, the contractual plan gives dealers and salesmen much higher *immediate* sales compensation than they can receive by selling mutual fund shares at level loads. Hence many dealers prefer to sell contractual plans.

The sale of load fund shares at a level load of from 7.5 percent to 8.75 percent is, as previously noted, considerably more remunerative to those in the securities business than the sale of other types of securities.<sup>155</sup> But the *immediate* rewards of selling a contractual plan surpass those of selling a voluntary level-load plan by an appreciable margin. During the first year of a \$600-a-year contractual plan, the selling organization earns \$300. During the first year of a \$600-a-year voluntary plan sold at a level load of 8½ percent, the selling organization earns only \$51.

#### 11. The no-load funds

As previously noted, there are at present approximately 60 mutual funds registered with the Commission that offer their shares at net asset value without the imposition of a sales load.<sup>156</sup> No-load funds are almost always externally managed.<sup>157</sup> Their external investment advisers are usually either established investment counselors who

<sup>154</sup> Many no-load funds also offer voluntary plans for the accumulation of their shares on an installment basis.

<sup>155</sup> See pp. 53-54, supra.

<sup>156</sup> Some no-load funds charge a redemption fee of from one-half of 1 percent to 1 percent of the net asset value of shares presented for redemption. Unlike sales loads, however, redemption fees are paid directly to the fund and inure to the benefit of its remaining shareholders. Redemption fees serve two purposes: (1) they tend to deter speculation in the fund's shares; and (2) they cover the fund's administrative costs in connection with the redemption.

<sup>157</sup> The only large internally managed no-load fund registered with the Commission at the present time is Eghm Trusts, which had assets of approximately \$170 million as of June 30, 1966. Its shares are available only to high-ranking employees of the General Electric Co. and to members of their immediate families.