Harry P. Schaub, Inc.
Newark, NJ

February 21, 1968
Our 35th Year

Mr. Orval L. DuBois, Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Re: Proposed Rule 10b-10

Dear Mr. DuBois:

In reference to the Commission's proposal to adopt Rule 10b-10 under the Securities Exchange Act of 1934 (as set forth in Release No. 8239) we would like to take this opportunity, as a registered broker -dealer, to present our views and comments.

May I refer you to the enclosed paper entitled <u>A Dealer Looks at the S.E.C. Report on Mutual Funds</u> dated June 1, 1967. On page 10, under the heading "Allocation of Mutual Fund Brokerage Commissions", I have set forth my views and proposals on the subject which I urgently suggest the members of the Commission read and consider.

I am enclosing five (5) extra copies of this letter together with copies of the above mentioned paper, It will be greatly appreciated if you will pass these along to Chairman Cohen and the other members of the Commission.

Respectfully yours.

H. Peter Schaub, Jr.

A DEALER LOOKS AT THE S.E.C. REPORT ON MUTUAL FUNDS

By H. Peter Schaub, Jr.
President, Harry P. Schaub, Inc., Newark, N. J.
Member National Association of Securities Dealers, Inc.

The following are my personal comments and observations on the December 2, 1966 report of the Securities and Exchange Commission entitled "Public Policy Implications of Investment Company Growth". Although I have read most of the 346 page Report, this memoranda is not an attempt to discuss, analyze or comment on the entire S.E.C. Report and the recommendations contained therein. <u>It is my purpose to present the views (on certain aspects of the Report) of a comparatively small retail broker-dealer based on our approximately twenty-five years experience in selecting and recommending mutual funds</u> (open-end investment companies) to help solve investor's problems.

Justification For S.E.C. Report

The Letter of Transmittal which accompanied the S.E.C. Report to Congress from the Commission explains that the report is submitted pursuant to section 14 (b) of the Investment Company Act of 1940, which authorizes the Commission if it believes "that any further increase in the size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation" and to report the results to the Congress.

It is doubtful that anyone questions the right or authority of the Commission to make such a study. In the light of the obvious dramatic increase in the size of the mutual fund industry, there should be no objection to a thorough study of it. Unfortunately, the S.E.C. appears to have (1) presumed that the growth and change raises important questions of public policy and (2) set out to gather voluminous statistical and other data to "prove" or justify the Commission's hypothesis.

The Report is replete with statistics which show the amazing growth of mutual funds between 1940 and 1965 in terms of number of shareholders (6. 7 million shareholder accounts), total assets ($33 billion), gross sales charges ($260 million), total advisory fees ($130 million), and brokerage commissions generated ($100 million). To the best of my knowledge, however, the S.E.C. fails to mention (omission of material facts?) that since the establishment of the first mutual fund in 1924, the industry has paid its shareholders income dividends totaling $7,104,693,000. Since 1926 when the first capital gain distribution was made, shareholders have received a total of $6,872,405,000 in such payments. For 1966 alone these payments consisted of $875,113,000 dividends and $1,318,463,000 capital gains.

In suggesting that the S.E.C. failed to include these highly significant figures; I must, in fairness, state that I did not read all of the 1,303 footnotes which are printed in 6 point closed type. (Can anyone imagine a mutual fund getting away with such small type in their prospectus?)

What has the fact that mutual funds have grown so much in size have to do with investor costs, i.e., sales charge and management fees? Are these hidden charges of which the investor needs to be aware? Docs the present Investment Company Act fail to require full disclosure of these and other costs? Perhaps, the answer simply is that the total dollar amounts are staggering to the S.E.C. Why has it taken the Commission a quarter of a century to suddenly concern itself with the question of "costs to investors"? The Commission's answer is to the effect that the investment company industry was so small 27 years ago that it was unimportant that mutual fund shareholders in 1940 paid the same sales charges and advisory fees which the S.E.C. today considers to be excessive.

The Philosophy of Security Regulation

The major foundation for the present federal and state securities laws is based upon the principle of "disclosure". These laws, in substance, require some form of disclosure either to the public or to regulatory authorities seeking to protect the public. Because of these disclosure requirements it has often been said that the mutual fund industry operates in a "gold fish bowl".

The S.E.C. Report states in Chapter II, page 63: "The Securities Act, the Securities Exchange Act and the Advisers Act supply significant protection to investment company shareholders as well as other investors. Primarily, however, those statutes are concerned with disclosure and with prevention of fraud. The Investment Company Act takes a different approach. It reflects a belief that investment companies present special problems which require that disclosure and controls aimed at the prevention of fraud be supplemented by further regulation."

The controls and further regulation referred to consist of 77 pages of the most stringent and far-reaching regulations to ever govern any industry. The Commission readily admits that disclosure requirements apply to investment companies to an even greater extent than to most other types of publicly held enterprises. For example, the Securities Act of 1933 is essentially a disclosure statute. It's primary purpose is to provide purchasers of securities with information material to informed investment decisions on public offerings of securities. Basically the Securities Act requires the filing of a detailed registration statement with the S.E.C. and the issuance to each purchaser of a prospectus containing basic information contained in the registration statement.

The issuers of most securities, after the public offering is over, are not required to keep their registration statements up to date. Most mutual funds, on the other hand, are continuously offering their securities to the public and, therefore, are required to periodically revise their registration statements (usually annually). Consequently, the Securities and Exchange Commission receives a continuous

flow of current information concerning the funds and their securities. Just as with other types of public offerings, if the S.E.C. finds a mutual fund's registration statement to be inaccurate or inadequate, it can terminate the offer and sale of the fund's shares by suspending the effectiveness of its Securities Act registration statement.

In addition, the Investment Company Act subjects all investment companies registered with the Commission under that Act to the proxy solicitation and periodic reporting rules adopted by the commission under the Securities Exchange Act of 1934.

Between the required current prospectus, the proxy statement and the S.E.C. "Statement of Policy" which pertains to mutual fund advertising and sales literature, it should be evident that the prospective fund purchaser certainly has available adequate, relevant information upon which he can make an "informed investment decision".

The mutual fund industry is already subject to the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the Investment Company Act of 1940 and the Internal Revenue Code. The S.E.C. wants to superimpose yet another layer of rules and regulations but has failed to demonstrate that such additional authority will, in effect, protect investors or serve the public interest to any greater extent than as provided in existing laws. Except for the Commission's obvious attempt to justify a compulsion to get into the field of rate regulation, the S.E.C. Report can not and does not document any abuse, monopoly, lessening of competitive forces or harmfully changed circumstances for which there is no present remedy at law.

New Growth, What Kind?

On October 16, 1960 U. S. Senator Harrison A. Williams, Jr. (D-NJ) gave an address before the National Association of Investment Companies (now known as the Investment Company Institute). In this address entitled "New Growth, What Kind?" he said:

"The course of the investment company business from 1940 has been a steady growth, a healthy growth, a growth which has been attuned to the expansion of our economy, and a growth which has been directly related to the climate of our times. I'm sure you all agree that the Investment Company Act, with its realistic, though complex, pattern for regulation, has provided the framework which has made this growth possible."

In discussing the growth in the number of investment company shareholders (from 400,000 in 1940 to 2.5 million in 1960), Senator Williams made the following observations:

"From a personal point of view these shareholders have supplemented personal plans for their own security by equity investment. From a national point of view the base of ownership of our means of communication, of production and of distribution has been immeasurably broadened. Thus investment companies have made an important contribution to the development of what Keith Funston, President of the New York Stock Exchange, has called 'the people's capitalism'."

In the same address Senator Williams referred to an article which had appeared in the Harvard Business Review in November 1949 which predicted that the mutual fund industry would be a $50 billion business within the next decade. The article further suggested that the funds had grown so large that they (1) were the chief cause of thin lackadaisical markets and influenced security prices, and (2) they are becoming a dominant and potentially dangerous voice in corporate management.

The Senator's comments on this Business Review article are interesting in the light of the present S.E.C. Report. He said:

"That article appeared, Gentlemen, in November of 1949 -- eleven years ago. Yours is not a $50 billion industry, today, nor have you, I am certain, reached the peak of your growth. There have been thin markets and, if you will, thick markets, since that time, and we have seen no evidence that investment companies have either dominated or influenced those markets except, perhaps, in the direction of stability. Nor have I seen any evidence that investment companies have sought to control corporate management affairs."

On the subject of government's (Congress, that is) responsibility to help educate the investing public he strongly recommended that the industry undertake an educational program "to insure that investors and shareholders are not only informed, but that they understand the information they receive. The right to vote of the corporate shareholder means little if he doesn't understand the basic issues involved when he casts his votes. " He went on to say:

"Here, it may well be that an educational program calls, not for substantial changes in your literature and your reporting, but for changes and improvements in the dealer-salesmen field -- where direct personal contact is made with members of the public."

<u>As a recent member of the District #12 Committee of the N.A.S.D., I can testify to the fact that substantial changes and improvements have been made, in the</u>

dealer-salesmen field to insure that we have more properly informed and educated better qualified dealers and salesmen than we had as recently as 1960 when the Senator made this address.

On the subject of government regulation he made these comments:

"...I would like to emphasize that government regulation is usually most effective, when the regulators and the regulated keep open the lines of communication."

"One last word. I know of no representative, of either major party, who is not dedicated in principle to the free enterprise system, and who does not recognize that in our society, people engage in business for the purpose of making a profit. I would be most reluctant to see the development of limitations which would conflict with these principles. In the securities area the principle of full disclosure has been developed to insure that investors are informed; in the investment company area the principle of voting rights has been superimposed to insure that informed shareholders have the power to exercise control." (Emphasis added)

Perhaps you are wondering why I have quoted so many excerpts from a speech made nearly seven years ago by the junior senator from New Jersey. Senator Harrison A. Williams, Jr. is chairman of the Securities Subcommittee of the Senate Banking & Currency Committee which is scheduled to hold hearings during the week of June 19th on the S.E.C.'s legislative proposals to amend the Investment Company Act of 1940.

The legislative proposal was introduced in the Senate (S. 1659) by Senator John J. Sparkman and in the House (H.R. 9510) by Rep. Staggers and Rep. Moss.

Do Mutual Funds Serve The 'Public Interest'

The very first page of the S.E.C. Report admits: "No attempt has been made in this report to assess the merits of investment company securities relative to other types of securities... Its primary purpose (the Report) is to describe and assess the growth of the investment company industry ... and to present recommendations for changes in the Federal law that will ... assure fairer treatment to the millions of Americans -- most of them of modest means -- whose appraisal of their own needs and circumstances has led them to invest many billions of dollars in those companies." (Emphasis added)

How can the S.E.C. realistically, honestly and logically put on trial a $35 billion industry without assessing the merits of its securities as an investment media relative to other forms of investment. It is because mutual funds are a unique form of investment that they have grown so in size. To attack the growth and size of mutual funds without considering or evaluating their benefits -- without

determining if and to what extent funds serve the public investor -- how can there be any logical justification for many of the S.E.C.'s legislative proposals.

The great shortcoming of the Report is the complete absence of any survey or opinion poll of mutual fund shareholders. Since the S.E.C. has built their case on "protection of investors" would it not be logical and important to find out how the "typical" mutual fund shareholder feels about his fund investments. The S.E.C. has spent eight years and probably millions of dollars of taxpayer's money on this study, dating back to their employment of the Wharton School in 1958. Instead of assuming that mutual fund shareholders are being abused and used, why not go to these supposed "victims" and obtain the truth.

I am confident, without reservation, that any investment dealer or salesman, who has honestly and intelligently sold mutual funds to his customers, would welcome a completely independent survey of shareholder opinion as to the sales load, management fees, performance, benefits and merits of the funds they own.

Mutual Funds As A Form Of 'Insurance'

Mutual fund literature constantly stresses their principal advantages, namely: diversification, continuous supervision and professional investment management. In spite of the fact that these terms have become trite from constant usage they still are true descriptions of the benefits which a mutual fund shareholder obtains. Some years ago, Dudley F. Cates, long prominent in the selling end of the mutual fund industry (presently with Carl M. Loeb, Rhoades) wrote an article for Trusts and Estates magazine entitled "Are Mutual Kinds Expensive?" in which he discussed the "costs" and advantages of buying mutual funds versus buying a "few good stocks and bonds." In asking why so many investors willingly pay a sales charge he offers the following answer:

"Perhaps, we should think of mutual funds as a form of 'insurance'. An investor in the shares of almost any fund acquires certain protective advantages which, taken together, afford his investment a relative degree of safety -- greater in most cases than he could possibly achieve by himself. These advantages are inherent in the nature of funds, and include:

"1. Protection of principal -- Most Mutual Funds, except those of an avowed speculative nature, afford the investor a greater degree of stability than do individual stocks, and protection from total loss by reason of their diversification over many companies, industries, and types of securities. Mutual Funds usually reflect composite market action, which tends to level the much wider swings of the component stocks and bonds.

"2. Continuity of income -- The record shows that Mutual Funds of the "open end" type have paid dividends in every quarter, or other scheduled period, since their inception. The amount of the dividends will vary, but the shareholder is assured of receiving a regular return commensurate with the average quality of the many securities in the portfolio.

3. Competent management -- Although Fund managers do make honest errors of judgment in the selection of certain securities, these errors are likely to be less serious and more quickly corrected than those of less well-informed investors. Certain restraints are placed on Mutual Fund managements, nearly all of which are registered under the Investment Company Act of 1940. Performance records, moreover, are the subject of continuous comparison.

4. Liquidity -- Repurchase provisions are clearly defined in the Investment Company Act of 1940. Nearly all Funds redeem their shares at prices equal to the net asset value underlying each share. This enables the investor to liquidate any portion of his holdings quickly -- a fact of great importance to trustees with large holdings and numerous accounts. Investors in individual securities must sometimes wait for bids on a varied list of issues, some of which may not attract buyers within a reasonable time nor at hoped-for prices.

5. Convenience -- Over a period of years owners of Mutual Fund shares are spared most of the worries and difficult decisions that are the lot of other security owners. They automatically delegate such problems as voting proxies and approving changes in capital structure to their investment managers, who are paid to do a competent job of representing their best interests. Fund shareholders receive regular quarterly or semi-annual dividends, eliminating the annoyance of collecting and accounting for many small checks or coupons from a variety of securities.

“For the estate owner or executor the problem of equal gifts and bequests is also simplified through the use of Mutual Fund shares, since each beneficiary may be allotted the same amount and quality of securities as every other. In addition, the donor confers the advantages of continuous professional management with these shares, protecting the recipient from his own possible inexperience in investment matters.”

We have a number of clients whose goal as they approach retirement is to have a professionally managed "investment program" or "living trust". They have selected the shares of certain mutual funds whose stated investment objectives coincide with their own individual long-term aims and objectives. Yet, the S.E.C. views mutual funds as just "another security" completely disregarding the differences and advantages set forth above. If we conclude that mutual funds are

"investment programs" rather than just a "few good stocks and bonds", the next step is to explore the questions of "costs".

Half A 'Load' Is Better Than None?

In discussing the sales charge or "load", the S.E.C. Report states: "Investors pay higher sales charges for mutual fund shares than for listed securities than they might buy directly for their own accounts". The Report then cites a comparison of the cost between investing $4,000 in one single stock versus a mutual fund. The fallacy of this comparison is so obvious to sophisticated investors that it hardly deserves rebuttal. Unfortunately, the less informed investor can be seriously mislead by the S.E.C.'s "matter of fact" attitude and presentation.

The following brief facts must be considered in evaluating the S.E.C. statement on comparative costs:

1) The mutual fund sales charge covers both purchase and sale.

2) The S.E.C.'s example of purchasing $4,000 of 100 shares of a round-lot stock did not provide for the subsequent cost of selling it.

3) The S.E.C. should -- in the spirit of stating material facts -- have compared the costs of buying, not one stock, but a diversified list of at least 50 stocks where the in-and-out brokerage commissions could run as high as 13 1/2% on a $4,000 investment.

4) Mutual fund shares are not simply another security but rather an investment program emphasizing long-term objectives consisting of a managed and diversified portfolio of many securities.

5) Mutual fund investors should amortize the acquisition cost or "load" over the period of years they own a particular fund. For example, the cost over a ten year period is less than 1% a year; 20 years reduces it to 4/10 of 1% per annum.

The "Locked-In" Investor

Has the S.E.C. given any consideration to the fact that once an investment dealer (or his salesmen) have invested their customer's money in mutual funds there is little justification for taking the customer out of his fund shares?. Even if a change in the investor's circumstances or objectives -- such as a shift from growth to income upon retirement -- warrants a conversion from one fund to another, this can be done in most cases at a reduced sales charge or upon payment of a nominal $5 transfer charge. Had the security dealer recommended individual stocks instead of fund shares, there would probably be the opportunity

for the dealer to buy and sell many times during the lifetime of a typical account, thereby generating in-and-out commissions. This is the reason that an account consisting only of mutual funds can be described as "locked in" as far as the dealer is concerned.

In my own business we have a number of customers who purchased mutual fund shares more than twenty years ago and still own the same shares today. We have situations where through gifts and inheritance these shares have passed thru three generations in a family without the payment of any additional commission. While we were paid what the S.E.C. considers to be an "excessive" commission -- twenty or more years ago -- we have received nothing since on these original purchases. Yet, we have continued to render full service to these accounts such as providing tax information, tracing missing dividends, lost certificates, handling the transfers of gifts and inheritances, and many other innumerable services -- all without cost to the customer or remuneration to us.

In recent years, as clients reached retirement age, we have encouraged and assisted them in setting up check-a-month withdrawal plans using shares previously acquired. For these accounts we prepare annual summaries of their fund holdings so they can see where they stand financially and are able to decide whether to increase or decrease their monthly checks for the ensuing year. Our philosophy, stated simply, is that once an investor purchases any investment on our recommendation, his account is our responsibility as long as he continues to own anything purchased at our suggestion. We simply do not make a "sale" to a customer and then forget it.

I do not think our firm is unique in this respect. There are many independent retail dealers across the country who conduct their business in a similar fashion. During the past twenty years I have traveled around these United States and visited with other retail investment and mutual fund dealers and salesmen. I have "talked shop" with them at conferences, conventions, work shops, etc. and know they render many of the same services to their customers including those customers who only own fund shares, even though it may have been years since they made their commission on a mutual fund sale. I think possibly the Securities and Exchange Commission has overlooked the importance to millions of investors of the sincere, honest and professional guidance and service provided by thousands of smaller investment firms.

It would, indeed, be unfortunate if implementation of the S.E.C. legislative proposals forces many of these firms and their registered representatives to leave the securities business to earn a living elsewhere. The S.E.C. disregarding the realities of this situation apparently believes that dealer firms can continue to render these personal and important services to their clients and continue to have profitable business operation in spite of a 45% to 50% or more reduction in

gross income. In other words, the S.E.C. -- to paraphrase an old saying -- is telling us that "half a load is batter than none".

Reinvestment Of Mutual Fund Dividends

The S.E.C. Report states that many mutual fund shareholders use the dividends and capital gains to acquire additional shares through "reinvestment plans". Because of the special nature of capital gain distributions (derived from principal rather than from investment income), all mutual funds permit and, in fact, encourage shareholders to reinvest at net asset value without a sales charge.

Many funds, however, do impose the basic sales load on the reinvestment of income dividends with the bulk of the sales load going to the dealer who initially sold the shares. Apparently this practice, which is totally defensible and realistic, displeases the S.E.C. Their position is that (1) "loads on invested dividends are not related to or justified by any special selling effort apart from that involved in the initial sale"; (2) "nor can such loads be justified on the grounds that they are necessary incentives to 'sell' dividend investments"; and (3) the commission should be empowered to "prohibit anomalous and inequitable sales charges, such as the loads now imposed on the investment of dividends".

Once again, the S.E.C. (i.e., the staff people who prepared the Report) is handicapped by lack of actual and practical experience in the day-to-day business of selling securities, particularly mutual funds.

Let us assume that mutual funds did not offer such convenient reinvestment plans. What would the shareholders -- who do not need current income -- do with their dividend checks? The chances are they would deposit the dividends in a savings account until they had accumulated $500 to $1,000; then, they would withdraw the cash, contact their broker-dealer and invest these "savings". Before many mutual funds offered such reinvestment plans, this is exactly what many shareholders did. We still have many clients today who follow this practice of "saving" their dividends from mutual funds and other securities until they accumulate anywhere from a few hundred to several thousand dollars. When a shareholder chooses to invest "earned income" (such as salary or dividends from securities) he is really investing new "capital". If an investor owns individual common stocks and wishes to purchase additional shares of those stocks with dividends received, no one would expect the broker-dealer to handle the purchase transaction without a sales charge or commission.

In effect, what the S.E.C. is proposing is that all fund sales after the initial sale to a client should be made without any sales load. If the commission really subscribes to this theory, why don't they also recommend that all investors be

permitted to make subsequent purchases of any security, after the initial purchase, without paying any commission.

One other aspect of the S.E.C.'s questionable attitude regarding the "selling effort" and service performed by dealers in encouraging dividend reinvestment requires refutation.

Investment dealers perform an important service to mutual funds and their shareholders by continually selling new shares (Including shares purchased with reinvested dividends). These sales provide cash for further investment in portfolio securities and for meeting day-to-day repurchase (redemption) obligations, thereby avoiding the necessity of a fund having to sell portfolio securities for such purpose.

When sales of new shares exceed redemptions, they help a mutual fund to grow in size, and growth in size not only results in a lower ratio of expenses to assets but also makes it possible for the fund to attract experienced personnel and provide for continuity of quality management.

The failure of a mutual fund to continually sell new shares (including shares sold to investors who reinvest dividends) would lead to net liquidation (redemptions in excess of sales), and eventually the fund would either disappear or become a closed-end fund.

Allocation Of Mutual Fund Brokerage Commission

Mutual funds, in the management of their investment portfolios, are continually buying and selling securities, some funds more frequently than others. The S.E.C. estimates that for 1965, these portfolio transactions resulted in brokerage commissions of more than $100 million. The S.E.C. takes exception to the total dollar value of these brokerage costs and their allocation among various broker-dealers. The total subject of mutual fund brokerage costs is complex and it is not my intention to examine and comment on each assertion made by the Commission.

As long as mutual funds exist and use the service of independent broker-dealers for execution of portfolio transactions, brokerage commissions will be paid whether to a few or many investment firms. Some explanation of how funds allocate this business is necessary to an understanding of what the S.E.C. views as a major problem area.

Generally, brokerage commissions in the fund industry are allocated and directed for two primary purposes:

(1) To compensate those firms who provide a fund with special, detailed reports and analyses of market trends, specific industries and studies of particular stocks, collectively referred to as brokerage house "research". In addition, a number of brokerage firms furnish other services such as private wire facilities, custodial services, daily pricing of portfolio securities. Brokerage houses usually provide these services in return for brokerage commissions.

(2) The remainder of a mutual fund's disposable brokerage commissions, frequently substantial, is allocated or directed to mutual fund dealers who sell the fund's shares. Frequently the amount of brokerage paid or directed is related to the volume of the dealer's mutual fund sales. This practice is commonly called "reciprocity" -- doing business with people who do business with you -- an accepted custom in the business world.

Let's consider a typical and simple example of reciprocity. A dealer in the course of a year sells $300,000 worth of XYZ Fund shares to his customers. This is new money to XYZ Fund and presumably has to be invested by the Fund in securities. It is not unreasonable, however impractical it may be as discussed below, for the dealer to expect that some portion of this new money be invested through his firm at standard commission rates.

<u>As a practical matter, however, it is impossible for any fund to place direct orders with all the broker-dealers who sell their shares. Such a practice would impose burdens on fund trading departments and on the ability of fund managers to acquire or dispose of portfolio securities in the most inexpensive and efficient way. Furthermore, the fund managers understandably do not want the entire financial community to know what they are buying or selling.</u>

Because of these and other considerations, most funds concentrate their brokerage business among a small number of "primary brokers" believed to be especially capable of providing good executions. At the same time, they seek to distribute the commission income generated from that business to a much larger number of broker-dealers as "reciprocity". The methods of accomplishing this distribution are too complex to discuss here. The reason for their complexity is because the New York Stock Exchange prohibits its member firms from splitting commissions with non-members. (This whole business of reciprocity would be vastly simplified if the S.E.C. were to persuade the "Big Board" to permit its members to share commissions with non-members, either directly or as a "give-up", depending upon the nature of a given transaction).

On this subject, the S.E.C. Report quotes one dealer who wrote to the Commission, "A non-member dealer (not NYSE) works off his head to create millions in brokerage business -- and services the fund's clients for years and years in dozens of ways but can't get cash for this extra service. This is wrong!”

Aside from this problem, the most obvious way of spreading the fund's commissions among a number of brokers is to have the broker who receives the commission for handling a single order give portions of that commission to other brokers. When a broker surrenders part of his commission to another at the request of a mutual fund it is called a "customer-directed give-up".

Completely minimizing the fact that the mutual fund dealers do create millions of dollars in brokerage business, the S.E.C. argues that "the use of the fund's brokerage commissions as extra compensation to retail sellers of fund shares primarily benefits their advisor-underwriters rather than the funds and their shareholders". The S.E.C. seems to forget (although they devoted many pages to a discussion of the subject in their report) that the whole business of splitting commission, give-ups (call it what you will) is largely attributable to the simple fact that a mutual fund cannot divide the actual portfolio transactions among all its dealers. Can you imagine a fund with 2,500 to 3,500 dealers retailing its shares attempting to place orders with each of them?

The S.E.C. repeatedly asserts that firms which receives give-ups have nothing to do with the transactions on which the commissions are earned. Once again, the gentlemen from Washington have missed the whole point. These fund dealers are "giving up" the opportunity to handle the portfolio transactions directly and, as a "consideration", are compensated indirectly. If anyone has a right to complain it is the small dealer who must sit on the sidelines and watch the big firms haul in the commissions totally unrelated to the amount of fund sales which the big firms have contributed. How does the S.E.C. propose to solve this problem?

The Commission proposes that (1) all securities exchanges and the NASD change their rules to abolish customer-directed give-ups and (2) the exchanges consider changes in their commission rate schedule to provide a volume or institutional discount for mutual funds and other institutional investors.

If the commission give-up is eliminated, then the mutual funds' brokerage commissions are going to be concentrated among a comparatively few select "primary brokers" some of whom may sell little or no mutual fund shares. Even if quantity discounts are instituted, these same brokers will still be skimming off whatever commissions are involved.

I have no particular objection to the idea of quantity discounts. It exists in most businesses including, ironically, the mutual fund industry which instituted the volume discount in the securities business. As the S.E.C. suggests such a discount would recognize the generally lower costs to brokerage firms of executing transactions for institutional investors.

If the S.E.C. really wants to correct an inequitable situation -- which indirectly affects the public investor -- let the Commission devote its talent and energy to encouraging <u>total reciprocity</u> and <u>commission-sharing</u> between all S.E.C. registered broker-dealers regardless of whether they are members of a stock exchange. The Detroit Stock Exchange and some of the other regional exchanges presently offer 40% to non-stock exchange members on a split commission basis. <u>If every qualified, registered broker-dealer in the country can trade in any market in any security and receive some commission or compensation this will (1) increase competition in and among the various securities markets (stock exchanges, third market, over-the-counter, etc.) and (2) not restrict those securities on which they presently can make a commission.</u>

The S.E.C. in its preoccupation with the question of costs has taken the position that mutual funds pay "substantially" higher advisory fees than are paid for investment management by private individuals, pension and profit sharing plans, trust accounts, insurance companies, etc. For an excellent, informed, and well-documented answer to this assertion I recommend to the reader a memorandum entitled "An Emphatic Rebuttal" by William F. Shelley, President of Vance, Sanders & Company, Inc. Vance Sanders are the sponsors of Massachusetts Investors Trust (the oldest mutual fund in the U.S.), Boston Fund, and several other highly regarded and well-managed funds. Mr. Shelley has done an excellent job in directly challenging many of the S.E.C.'s inaccurate and misleading facts and figures.

Underlying the S.E.C.'s proposal for controlling management fees is the implication that although mutual funds have grown substantially in size the funds have failed to share the "economics of size" with their shareholders in the form of reduced advisory fees and related expenses. <u>The Commission does admit, whoever, that nineteen out of twenty of the largest externally managed funds pay lower advisory fees today than in 1960.</u> For eleven of these funds, the changes were made in whole or part in connection with settlements of stockholder suits which I will comment on below.

One frequently used and widely publicized measure of shareholder costs is the "expense ratio" which is the ratio of management costs (advisory fees plus non-advisory services) to average net assets of a mutual fund. There has been a significant decline over the past 14 years in these expense ratios which constitute the main operating expense to shareholders. Interestingly enough, the S.E.C. Report includes a tabulation showing the reduction in the expense ratios of 18 of the largest externally managed funds which showed a decline in the median expense ratio, from .66% in 1953 to .54% in 1962. This is equivalent to a decrease of 18%, nearly one-fifth. But, for some unknown reason, they fail to tabulate the expense ratios for fiscal 1965 which is readily available. (It took me only five minutes to look up the figures in "Investment Companies 1966"

published by Arthur Wiesenberger & Co.). Wiesenberger's latest figures for the most recent fiscal year shows these same 18 funds to have a median "expense ratio" of .46%. In other words this ratio has dropped an additional 15% since 1962. Stated in dollars and cents the average annual cost per $1,000 mutual fund holding was $6.60 in 1953, $5.40 in 1962 and currently is approximately $4.60 per $1, 000 of asset value. These figures certainly refute the allegation that shareholders have not benefited from the "economies of size" as the funds' assets have grown year by year.

The S.E.C. proposes that the Investment Company Act be amended to impose a "standard of reasonableness" giving the Commission power to institute actions to enforce such a standard even though shareholders and directors of a fund had, by vote, approved an advisory contract setting forth the management fees. Coupled with this proposal would be an express provision that all compensation paid to any person affiliated with a fund (directors, officers, trustees, etc.) be reasonable.

These proposals would put the S.E.C. in the position of being both judge and jury. How can the S.E.C. or any other agency override a management contract previously ratified by the shareholders themselves. Isn't the value of such management a matter of judgment on the part of the persons who pay for them?

The related subject of compensation such as fees and salaries paid to officers, directors, trustees of the fund, its underwriter and its investment advisor poses some vital questions. For example, should the president, other officers and directors of banks, insurance companies and broker-dealer firms be subjected to "clearly expressed and readily enforceable standards of reasonableness"?

Shareholder Control and Voting Rights

The proposal to amend the Investment Company Act to impose a standard of reasonableness with respect to management fees is based on the Wharton School Report which concluded that shareholder voting rights "appear to be of limited value" because mutual fund shareholders are widely distributed and ownership less concentrated than most other publicly held companies of comparable size. What about the stockholders of American Tel. & Tel., Ford, General Motors, Standard Oil of New Jersey, U. S. Steel, etc. who are scattered throughout the 50 states and foreign countries?

The S.E.C. also suggests that fund shareholders are not in a position to bargain effectively with mutual fund management and this is another reason for the S.E.C. to disfranchise the fund shareholder because the Commission presumably knows what's best for the shareholder.

To top if off, the S.E.C. (via the Wharton Report) observes that "...mutual fund shareholders tend to be passive. Generally, only a handful of them attend annual meetings, despite the efforts by some fund managements to encourage attendance." Has it occurred to anyone at the Wharton School or at the S.E.C. that the reason may simply be that the shareholders are satisfied!

As suggested in my discussion of the sales charge, instead of making a lot of unfounded assumptions about what's right or wrong in the hypothetical case of Mutual Funds vs. The Shareholder, why not conduct an independent survey to find out how unhappy or dissatisfied the average fund shareholder is about all these people seeking to take advantage of him.

Future of The Small Dealer

What I have written up to this point has been from a professional point of view, namely that of a broker-dealer with a background of intimate knowledge of the mutual fund industry, its shareholders and the regulations which govern the industry. I have tried -- as much as one is able under the circumstances -- to be impersonal and objective without regard to what effect implementation of the S.E.C. proposals will have upon my own firm and, personally, upon me.

I would be dishonest if I were to suggest that I have no personal interest in what the Congress does about the S.E.C. Report and recommendations. I have a very vital interest and will endeavor to summarize what the possible economic consequences will be to my firm and the many other dealers with similar businesses.

The National Association of Securities Dealers in April released their detailed study of the S.E.C. Report entitled "Economic Consequences For The Securities Business". Their basic findings, supported by impressive documentation and statistical data, are summarized in the first two paragraphs, as follows:

"The 3,600 members of the National Association of Securities Dealers will suffer a drastic loss of income and a great many firms may be forced to leave the business should the proposals of the Securities and Exchange Commission, legislative and otherwise, relating to open-end investment companies (mutual funds), actually take effect." (Emphasis added)

"Moreover, it appears that there could be significant reductions in the profitability of the comparatively small mutual, fund transaction so that large numbers of potential investors may no longer have this important investment medium brought to their attention. Salesmen who now find it worthwhile to seek out investors with modest means, to the point that the average mutual fund share

purchase today is $1,240, may no longer be able to afford to offer this unique type of security to those investors who perhaps need it the most."

The three areas among the Commission's proposals which will directly affect my own firm are: (1) that sales charges be reduced by approximately 40 percent; (2) that the traditional system of reciprocity be substantially altered by elimination of the customer-directed give-ups (or commission sharing) on fund portfolio transactions; and (3) that the sales charge on reinvestment of income dividends be eliminated.

The N.A.S.D. survey (referred to above) was conducted by the management consulting firm of Booz-Allen Applied Research, Inc. who scientifically selected a representative sample of 185 NASD member firms. Its purpose was to estimate the economic impact of the S.E.C. proposals on the association's 3,600 members and 90,000 salesmen. The survey cross-classified the firms by (1) size based on total gross income ranging from less than $100,000 to more than $2,500,000 and (2) ratio of mutual fund sales income to total gross income.

In the particular grouping which encompasses firms of our size with a comparable degree of concentration in mutual fund sales, the survey estimates these firm's 1966 net profit after taxes would have been reduced four-fold if all the S.E.C. proposals had been in effect last year.

But more significant is the fact that these firms would have been forced from a profit to a loss position and the resulting net loss would have been three to four times as great as the previous profit.

I have applied the NASD calculations to our own 1966 operations and find that their estimates are surprisingly close. Our business is concentrated in three principal retail areas: mutual funds, tax-exempt bonds, and over-the-counter stocks (including "third market" transactions). The importance of our mutual fund sales is indicated by the fact that while they represent only 25% to 30% of total dollar sales, they contribute 45% to 55% of gross income including fund directed give-ups. Offsetting this, however, is the fact that transactions on the New York and American Stock Exchange -- which we handle as an accommodation for customers -- represent 8% of sales but produce no income.

Perhaps the most significant figure in our operation is the Ratio of Gross Income to Total Sales. For 1966 this gross income was equivalent to 1.90% of sales and the average for the last ten years has been 1.87%. Out of this gross income we must pay all our expenses for rent, telephone, salesmen's' commissions, payroll taxes, interest, clerical and executive salaries, insurance, office supplies, etc. The dollars left, if any, are subject to corporate income taxes. In contrast, retail operations such as department stores and supermarket chains show a 3% to 9%

gross operating income to sales. Obviously, I could cite many industries with considerably higher profit margins.

Assuming no change in the make up and volume of our sales, the S.E.C. proposals would decrease our gross income by approximately thirty percent (30%). On this basis it would be virtually impossible for us to continue in business unless the principals in our firms wish to subsidize the business and pursue our careers as a hobby.

Up to this point, our business has provided a comfortable, but modest income for our principal officers who are also the principal producers. Fortunately, for us (and our customers) we each have additional income from investments (including mutual funds) purchased in the days when the securities business was more rewarding financially and the overhead costs of operating an office were so much lower. If the S.E.C. is interested I will be happy to itemize what we paid 10 to 15 years ago for rent and clerical salaries and other expenses which have practically doubled in this period of time. When I joined the firm in 1945 we were paying secretaries and bookkeepers about $45 per week.

If, in spite of increasing overhead, we can continue to augment our sales and resultant commission income, we will be able to stay in business and continue to serve our customers' best interests. When a broker-dealer has a financially secure operation (even at a break-even level) together with a good reputation and an appreciative clientele, he doesn't have to weigh each recommendation with the thought "how much can I make on this transaction?" If we feel a client should invest in tax-exempt bonds instead of a mutual fund, we sell him the bonds knowing that our profit or commission on the sale will be substantially less than we could make on a mutual fund sale. We have even recommended stocks listed on the Exchange which is a profitless transaction for us.

If, on the other hand, the S.E.C. persists and is successful in obtaining Congressional approval of these legislative proposals, our business (i.e., the retail security dealer) will become a matter of survival whereby, of necessity, our own selfish interests will preclude serving the best interests of our clients. No business or profession can long be successful if based on a philosophy of self-interest.

Conclusion

In 1933 my father, who is still very active in business, established our present firm, in his own words, "so that I might continue to serve my clients guided by the same philosophy adopted when I first entered the investment business in 1921". A restatement of those policies and principles seems an appropriate conclusion to this commentary, not so much because they represent our personal viewpoint,

but, more importantly, they express the philosophy of so many retail security dealers and salesmen who I personally know. The following excerpts are from our brochure entitled "The Management of Your Money".

"We believe that the success of an investment firm is measured in terms of the welfare of its clients. Each step we take to provide better and sounder management of our client's money marks progress in our profession, adds prominence to our business and assurance to our future.

'"The real clue to our progress (and our clients') is whether the service would be satisfactory to us. Investors are just as interested in preserving their income and capital as we are in protecting our own. They are just as appreciative of service and information as we would be. In short, investors are human beings who appreciate genuine interest and careful dealing. They repay such methods not only with their continued business but by telling their friends. Our many years of continuous service to investors has proved this to be true.

"Our firm assumes that the retail investment business is -- or should be -- a professional service. We serve our clients by rendering a personal investment service. Strictly speaking -- the firm does not merely "sell" securities -- instead we act as "professional buyers" in selecting the securities which best fit our client's requirements. We begin with the investor's needs and preferences and assist in the development of a sound investment program. Our detailed knowledge, experience and judgment are available to our clients at all times. This method places more responsibility on us and lightens the investor's burden.

"The investment securities business carries the awesome responsibility of handling the money which represents the accumulated total of hard work and self-sacrifice of many of the people in this country. There are, perhaps, few fields where the need for help is so great in proportion to the number of people qualified to supply it. How well an investment firm discharges that responsibility inevitably and justly will determine its future."

Given the right environment -- that is, the opportunity to conduct a professional investment business, to earn a living and make a reasonable profit free of unduly restrictive rules and regulations -- the mutual fund dealer can continue to serve the investing public as in the past. The S.E.C. Report (page 56) in discussing the sales load does recognize the need for and benefit of compensation to stimulate the growth of "the people's capitalism":

"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."

To this can be added the fact that the mutual fund dealers and salesmen have -- in return for the commissions earned -- enabled these millions of shareholders to provide for a hedge against inflation, finance children's educations, and build or supplement their retirement income. Thus, they have gained financial security and investment peace of mind.

I am convinced that the entire mutual fund industry is in favor of sound, proper and adequate regulation to protect the interest of the public provided that such legislation, including its administration and enforcement, is equitable, realistic, not unduly stringent nor harmful to continued operation of thousands of dealer firms who serve the public.

In conclusion, may I suggest that the Congress and the Securities and Exchange Commission reappraise, reconsider and restudy the present S.E.C. legislative proposals to determine if they truly are in the so-called "public interest".

June 7, 1967

<u>Background of</u>
<u>H. PETER SCHAUB, JR.</u>

Mr. Schaub attended Dartmouth College (Class of '44) and served in the U. S. Coast Guard during World War II. He joined Harry P. Schaub, Inc., Newark, New Jersey Investment Securities firm in 1946 and became President in 1963.

The firm, established in 1933 by his father, is a registered broker-dealer with the S.E.C. and a member of the National Association of Securities Dealers, Inc. Primarily engaged in the retail distribution of over-the-counter securities, the firm specializes in special industrial and utility situations, tax-exempt bonds and mutual funds. Harry P. Schaub, Inc. has conducted its business under the same name and family management since its founding and is one of the oldest investment houses in New Jersey.

Mr. Schaub recently completed three years on the N.A.S.D. District #12 Committee (1964-66), where he served as Chairman of the Dealer Service Committee. He is a former President of the Bond Club of New Jersey (1964-65). In 1963, representing the Bond Club of New Jersey, he worked with representatives of the I.B.A., N.A.S.D., Association of Stock Exchange Firms and others in conferences with the Attorney General of New Jersey on legislation to amend the state's Uniform Securities Law. Mr. Schaub has been studying, analyzing and selling mutual fund shares since 1946. He is an economics

instructor at Rutgers University Extension Division where he teaches a course on "Personal Investment Planning".

His other activities include being a Director (since 1963) of the Detroit International Bridge Company (known as the "Ambassador Bridge"). From 1949 to 1958 he was Secretary of the Lewiston-Queenston Bridge, Inc. and its Canadian subsidiary and served as President in 1959. He has been a Trustee of the Boys' Clubs of Newark since 1950 and in 1962-63 served as Chairman of the Board. He recently completed two years as Chairman of the New Jersey Area Council, Boys' Clubs of America. Other activities include: Director of the Newark YM-YWCA; President-elect of the Down Town Club of Newark; former Director and Secretary of the Newark Rotary Club (1955-59); and past President of the former Newark Athletic Club (1952-53).