The Investment Company of America
Los Angeles, California

March 28, 1968

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

Dear Mr. DuBois:

Re: Proposals of New York Stock Exchange and Securities Exchange Act Release No. 8239, Proposed Rule 10b-10

In Securities Exchange Act Release No. 8239, the Commission has asked for comments regarding certain proposals having to do with the brokerage commissions paid by registered investment companies. Briefly, the first of these proposals consists of a 5-part proposal made by the New York Stock Exchange to the Commission in early January. The second proposal is identified as Proposed Commission Rule 10b-10, which we understand to be a staff proposal which the Commission has under consideration.

The proposals made by the New York Stock Exchange are set forth in very general terms. This generality makes it difficult to appraise them in a definitive manner or to comment upon them in detail. Nevertheless, taken as a group, we believe that in principle the Exchange proposals are for the most part constructive.

We favor the Exchange proposal to incorporate a volume discount in the minimum commission schedule. We recognize that the development of a practical volume discount arrangement is a complex problem, but the principle of a minimum commission schedule which gives greater recognition to differences in the size of a transaction than is now provided is sound.

The complexities of the problem are evident. One of the most commonly suggested approaches to a volume discount is to tailor the commission to the size of the individual transaction. Another is to classify investors on the basis of their historic volume of commissions. Since not all transactions of a large investor are necessarily large, a volume discount related to the size of the individual transaction might appear to be most appropriate. On the other hand, such a commission rate structure might introduce a conflict between the desire to qualify for a reduced commission on a given transaction (or series of transactions) and the exercise of one's best judgment as to the most favorable execution of the transaction, apart from commission cost.

As an investment company, we are vitally interested in and dependent upon the existence of healthy markets for the securities in which we invest. We believe that one of the requirements for the maintenance of such markets is a financially sound and prosperous securities business. Thus, while we are interested in the brokerage cost of handling transactions, such cost is not the sole criterion of the soundness of a commission rate structure. Potential differences in investment performance resulting from a deterioration of the market mechanism could outweigh any potential savings in brokerage costs. It would be short-sighted to support rate changes which would impair the health of the securities markets.

These are by no means all of the complications involved. We cite them only to illustrate that while we are in accord with the principles set forth in the first of the five proposals made by the New York Stock Exchange, we are aware of the complexity of the task of implementing this concept. Nevertheless, we are confident that a viable arrangement can be developed.

We also favor the Exchange proposal as it seeks to strengthen the minimum commission structure that has been an important part of the securities business. The proposal to restrict participation in brokerage commissions to bona fide broker-dealers, combined with a reasonable volume discount schedule, would provide the basis for a realistic, viable system within which the securities business could operate. The minimum commission concept was originally instituted to prevent destructive price cutting that would destroy competition in the market by forcing all but a few of the largest firms out of business and in the process lead to a decline in the service and financial soundness of the securities business. We feel that the minimum commission concept continues to be valid, and should be preserved.

Within the minimum commission structure, the investor has the option with the give-up mechanism of deciding whether the brokerage commissions on transactions handled by lower-cost firms should be retained entirely by the executing brokers or, subject to the willingness of the executing brokers, should be shared with other members of the securities community. We feel that dealers who have sold shares of a fund are logical and proper potential candidates for consideration in the selection of brokers for the execution of portfolio transactions arising from the investment of the capital they have directed to the fund, not as compensation for having sold the shares, but reflecting the fact that they are in the business of buying and selling securities. In many cases, however, such dealers are not equipped to provide as favorable executions for a fund as are other broker-dealers; hence the most advantageous way to enable them to participate in the brokerage commissions arising from the investment of the capital they have directed to a fund is through the give-up mechanism. This procedure also makes it possible for firms which are not equipped to provide the most favorable executions but which are able to provide other services, such as research, to be compensated for their services through brokerage without penalty to the institution. A small firm developing capability in its research department, for example, can support this effort only through the receipt of brokerage commissions. It would be academic to suggest that the firm charge a fee for such services, since competition will not permit such a charge. If the research operation could not be supported by brokerage, the logical alternative would be for the firm to merge or for the individuals to join a large firm which is in a position to receive brokerage commissions.

Likewise, customer-directed give-ups have helped regional firms compete with much larger firms and perform their important role in raising capital for relatively small but growing commercial and industrial companies. Perhaps investors in listed securities thus help "subsidize" the underwriting costs paid by regional issuers. Though we have no evidence to document our view, we think that the opportunity for small but expanding businesses to gain access to the capital markets at reasonable costs is to the overall benefit of investors, and particularly institutional investors. We are certainly not prepared to declare inequitable, inefficient or undesirable the system of securities distribution and capital formation that has been in effect for so many years.

In the absence of a specific proposal, we can make only limited comment on that portion of the Exchange proposal which would impose a limitation on the percentage amount which might be given up by one member of an exchange to another member or to a non-member broker-dealer. In principle, it would appear to us not to be unreasonable for an exchange to establish such a limitation. From a practical standpoint, one would expect that the introduction of a volume discount in the commission schedule would tend to reduce the percentage of the commission which a firm would be wiling to give up. From this standpoint, it may well be that a percentage limitation would be unnecessary, but again, we do not oppose the principle of a limitation on the percentage of give-up. Whether we would oppose a specific proposal in this regard would, of course, depend upon the specific level of percentage limitation which was proposed.

We believe that the proposal of the New York Stock Exchange to amend its rules to permit access to the Exchange market for qualified non-member broker-dealers through a professional discount is, on the whole, constructive. We recognize that this might reduce the incentive of regional members of the New York Stock Exchange to maintain their memberships, and might reduce to some extent the volume of transactions in dually listed securities executed on regional exchanges, but we believe that an offsetting benefit would be derived through the ability of non-member broker-dealers to participate directly in New York Stock Exchange commissions on business which they originate.

The costs and obligations of membership on regional exchanges will undoubtedly continue to differ from those relating to membership on the New York Stock Exchange and a member of a regional exchange can and should continue to have both the opportunity and incentive to do a better job than his counterpart on the New York Stock Exchange.

We support the Exchange proposal to limit participation in brokerage commissions to bona fide broker-dealers. While it might at first appear to be to the advantage of the institutional investor and its shareholders to obtain the benefit of brokerage commission rebates, we believe that widespread adoption of the practice by which a few institutional investors now obtain rebates of a portion of the brokerage commissions arising from their portfolio transactions would be detrimental to the health of the securities business and consequently to the health of the securities markets upon which institutional investors depend. We believe that a far better way of permitting institutional investors and their shareholders to participate in any savings which may be derived from a large volume of portfolio transactions is through a volume discount arrangement.

Finally, it seems quite evident to us that if the New York Stock Exchange is to adopt certain of the restrictions which are contained in its 5-point proposal, these can be effective only if the regional exchanges impose restrictions which are essentially comparable. We do not believe, however, that absolute uniformity of rules among exchanges is necessary. On the contrary, we believe that regional exchanges may need some greater latitude -- just as they grant greater latitude in their listing requirements in order to exist.

Although most of our transactions in listed securities are executed on the New York Stock Exchange, we would not like to see that or any other exchange become the sole listed market. Regional exchanges perform certain functions which not only justify their existence, but support the view that the interest of investors would be better served by the continued existence of regional exchanges, rather than by their abolition.

Although we do not believe uniformity of restrictions among exchanges is necessary, we do believe that in one respect restrictions should be uniform; this is the limitation of participation in brokerage commissions to bona fide broker-dealers. We believe that the issue at stake is the survival of the minimum commission schedule approach to competition in the securities business.

It is important to distinguish between the minimum commission concept and the existing application of this concept. As indicated earlier, we believe that the need for minimum commission schedules rests primarily upon the fact that not all firms are equally efficient, and without some price shelter, the major thrust of competition would be directed toward price, rather than service. In such an environment, many small and medium-sized regional firms would never have started, and many would not have survived. Yet, as a group, the small and medium-sized regional firms perform an important function in the capital formation process. They are also the seeds from which larger, sometimes more efficient firms can grow. Destructive price competition could result in greater concentration, less regional service, and, in the end, less competition.

The present application of the minimum commission concept has, however, certain deficiencies. The most important of these, in our view, is the fact that it is based upon a business conducted in 100-share lots or relatively small multiples thereof. It does not adequately allow for transactions in units of several thousand shares. Thus, as we stated earlier, we support in principle the concept of a volume discount.

From the standpoint of the large investor, there are two basic approaches to curing the deficiencies which we have cited in the minimum commission schedule. One would be to encourage rebates to customers who are in a position, or within clearly defined limits can structure themselves, to qualify for rebates. The other would be to revise the commission schedule to give more adequate recognition to the size of the transaction. The first approach would, almost certainly lead to the disappearance of minimum commission schedules. The second approach would, be more direct and much sounder from the standpoint of the securities business and the investor.

While we are generally in accord with the proposals made by the New York Stock Exchange, we have serious concern about proposed Commission Rule 10b-10. As stated in Release No. 8239, "the reasoning on which the proposed rule is based is that if, ... a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so." The Commission has not defined what it means by the term "at his disposal." Does this mean within its existing organizational framework? Does it imply that a mutual fund manager would be regarded as being obliged to develop the "means," regardless of cost or capital commitment? If so, the logical corollary of this reasoning would appear to be that if a mutual fund manager fails to discover a means by which such recapture could be accomplished, no matter how circuitous the device, the mutual fund manager would be regarded as failing to fulfill his fiduciary duty. The ramifications of such reasoning are so dangerous and so numerous as to defy complete cataloging. We believe that an investment adviser's functions should be to make investment recommendations or decisions and, if charged with the responsibility, to arrange for the execution of authorized transactions to a maximum possible degree on the basis of most favorable executions. Whether personnel of the investment adviser or of the fund itself are responsible for the placing of orders, we do not believe that the interests of fund shareholders would best be served, in the long run, by placing order department personnel in the position where they would be compelled to defend every decision not to place an order in a manner which would permit direct or indirect recapture of a portion of the commission by the fund. Yet this is what the stated reasoning underlying the proposed rule would do. There would be an inevitable tendency for the "safe" course to take precedence over the search for the best execution.

One of the problems which the Commission cites as having arisen in connection with reciprocal business is the development of increasingly intricate means of channeling the benefits of brokerage to broker-dealers who are not in a position to receive or participate directly in the original commissions. When these proposals are made to a fund management, whether to fund officers or to the investment adviser who is responsible for the placing of orders, the fund management can make a decision based upon its own judgment of the propriety of the proposal. If it chooses not to accept the proposal, the only penalty is that the broker making the proposal will be disappointed -- and probably critical. In contrast, if one applied the reasoning given by the Commission for proposed Rule 10b-10 to the same situation, and a means were proposed which would make it possible for a recaptured commission to flow back to the fund, the fund management might feel compelled to accept a proposal which it might question from the standpoint of executions, simply to avoid the risk of being charged with breach of fiduciary duty for failure to utilize a legal device through which a particular commission or set of commissions could be recaptured.

The approach to proposed Rule 10b-10 appears to be based not only upon the reasoning as to fiduciary duty which is cited on pages 8 and 9 of Release No. 8239, but upon the further unstated premise that mutual fund investment advisers are generally in a position under the present rules of certain stock exchanges to recover a portion of the commissions arising from transactions execrated on those exchanges. Although it is true that many investment advisers are, by virtue of their role as principal underwriters of the mutual funds which they serve as investment advisers, registered as broker-dealers and members of the NASD, there are important exceptions to this generality. These exceptions create problems of more than academic interest if one assumes adoption of proposed Rule 10b-10 and acceptance of the reasoning, and the logical extensions thereof, which are stated as underlying the proposal.

For example, in the case of The Investment Company of America, the investment adviser (Capital Research and Management Company) and the principal underwriter (American Funds Distributors, Inc.) are completely separate companies. They are not under common ownership, nor is one the subsidiary of the other. Although American Funds Distributors is registered as a broker-dealer and is a member of the NASD, it does not receive any compensation (management fee or otherwise) from The Investment Company of America. Therefore, any brokerage commissions which American Funds Distributors might receive in the form of directed give-ups could not be applied by it to the reduction of compensation from The Investment Company of America, since American Funds Distributors receives none. On the other hand, Capital Research and Management Company (the investment adviser) is neither a broker-dealer nor a member of the NASD and hence not eligible to share in brokerage commissions. What steps would Capital Research and Management Company be obliged to take if proposed Rule 10b-10 were to be adopted? Any steps it might take to qualify for rebates of brokerage commissions would appear to be artificial, to say the least, and we submit that the encouragement of such steps by the SEC is not in the public interest nor in the long-term interest of our shareholders.

We believe that the approach contemplated, in proposed Rule 10b-10 is unwarranted and that to the extent there are in fact problems in the brokerage area, they can far better be resolved through a revision of the minimum commission schedule to give more adequate recognition to differences in size of transaction than now exists, and in general following the approach suggested by the New York Stock Exchange.

Without having before us a suggested schedule of volume discounts, we can only speculate as to the relative cost reductions which might result from the two approaches. It is probable, however, that even a modest volume discount applicable to all stock exchange commissions paid by a mutual fund would exceed in dollars the maximum commissions which could be recaptured on the basis of a complete flow-through of give-ups on regional stock exchange business computed at non-member rates. This equation would be changed only by the extension of non-member give-up privileges to more stock exchanges, increasing the percentage of permissible give-ups to non-members, and/or the placing of a higher percentage of transactions on exchanges permitting give-ups to non-member firms. The latter possibility, of course, is limited by the execution capability of the exchanges involved. With little question, if it is cost saving which is sought, the New York Stock Exchange approach would be more effective, and not involve the damaging conflicts of interest which would be involved in the proposed Rule 10b-10 approach.

We do not propose to comment upon the specific language in proposed Rule 10b-10. Our concern is not with language, but with concept, and in our opinion no amount of change in language in the proposed rule could offset the damaging consequences of adoption of this approach.

We strongly urge that the Commission not adopt proposed. Rule 10b-10 or any substitute rule designed to accomplish the result contemplated by the proposed rule.

Very truly yours,

Robert L. Cody
President