Some Aspects of the Mutual Fund and Investor Protection

Solomon Spiro
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INTRODUCTION:

THE MUTUAL FUND AND THE SMALL INVESTOR

Canada is a country of limitless horizons in economic development and growth. Canada today, with its vast natural resources, and increasing technological sophistication, all in the context of relative domestic tranquility as compared with other technological societies, stands at the threshold of a new era of affluence. Against this background, it is especially critical that all members of society share in this growth, in some way. Wage earners, those with small and limited incomes, must have some medium whereby they may conveniently invest relatively small sums of money in equities, in order to benefit from the upward trend in the country's economy.

Many Canadians place their savings in what are essentially fixed rate of return investments, such as, savings accounts, bonds, insurance and so on. The insurance company, which holds the individual’s savings, may itself invest in equities. But, regardless of how well the insurance company’s investments fare, the policy holder receives a fixed return, that is, one that may be considered to be guaranteed.1 Thus, the person who places his savings with an insurance company, or a pension plan, is far removed from the equities which these intermediaries may purchase.2

However, through the medium of a mutual fund, the individual enjoys a direct interest in the underlying equity shares of corporate stock, which is proportionate to his investment in the fund. Thus, the mutual fund is the vehicle which may bring ‘participatory capitalism’ to the small investor.

The average wage earner may not be inclined to purchase shares of stock directly through a stockbroker. He may, for example, be discouraged by his lack of sophistication in the field of business. His alternative may therefore be the mutual fund. The concept of the mutual fund, when conducted with integrity and honesty, has much to offer the small investor. Through the pooling of funds, it is said that he can obtain the benefits of professional investment, while, at the same time, he may invest relatively small sums of money on a periodic basis.

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2 Conventional plans assumed, as opposed to variable or equity based types.
The small investor need not be concerned with the collection of dividends and the subsequent re-investment of these funds. The mutual fund will collect and re-invest the dividends for him in the form of additional fund shares. Many funds will perform this service by investing the dividends at the net asset value of the mutual fund shares without adding a service charge. In addition, most mutual funds may be employed as vehicles for a Registered Retirement Savings Plan, whereby the investor may place a certain maximum amount of pre-tax income into the fund, for retirement purposes, and benefit by deferring his income tax to a period when his marginal tax rate will likely be at a lower point.³

Because of the principle that every saver or investor ought to have an opportunity to participate in the growth of a dynamic economy, and in view of Canadian Governmental fiscal measures,⁴ designed to encourage people, especially the small investor, to purchase Canadian securities, the mutual fund industry should be viewed as infected with the character of a quasi-public utility. It should be regulated in conformity with this assumption.

In fact, it would appear that a great majority of mutual fund investors are those who invest small amounts of money in the form of regular payments. The Porter Report found that "The average value of the 300,000 mutual fund shareholders' investments is about $3,000 and an increasing proportion of them have invested by making regular payments rather than lump sum purchases."⁵ The Porter Report concludes that, on balance, mutual funds "play a constructive role in mobilizing savings for equity purchases, particularly from smaller investors."⁶

The small investor, whose options are somewhat limited or restricted, comes to the mutual fund of necessity. He should be treated with careful consideration and fairness. The mutual fund sales organization or salesman should not take advantage of the fact that the small investor places his faith in those who appear to be far more knowledgeable in investment-related matters than he is. The small investor may be naive. For this reason, it would be wishful thinking on the part of the government to assume that disclosure alone is adequate to secure the objective of investor protection. The object should be to devise a framework of regulation which will bring 'capitalism' within the grasp of all citizens, at a reasonable cost, based on the efficient and honest operation of the industry. This would give the investor the confidence to invest his money in a mutual fund. He would then feel that he is participating in the growth of the country, possibly protecting himself from the effects of inflation, and perhaps providing himself with an annuity plan with some measure of inflation protection. In addition, he would benefit from the economies which flow from the pooling of the savings of many people.

³ Income Tax Act, R.S.C. 1952, c. 148, s. 79B. Tax Reform Bill, C-259, 1971, s. 146 retains the concept, and, in fact, increases the amount of tax-exempt income which may be placed in a fund.
⁴ Registered Retirement Savings Plan as described in the text. The Dividend Tax Credit, Tax Reform Bill C-259, 1971, ss. 82, 121 is designed to encourage investment in Canadian Securities, and to provide the greater benefit to shareholders with lower marginal tax rates.
⁵ Report of the Royal Commission on Banking and Finance (Ottawa: Queen's Printer, 1964) at 255.
⁶ Id. at 256.
SALES CHARGES AND MANAGEMENT FEES

The vast majority of the sizeable mutual funds charge a fee of approximately 8.5% of the amount invested for entry into the fund. The mutual fund itself, is a skeletal organization, which is created by a separate organization known as a management company, which usually performs the investment advisory function plus the administrative duties of the fund. The sales distribution organization is sometimes one with the fund, but may also be a separate organization or corporation, though controlled by the same individuals who control the management company.

The mutual fund agrees to pay the management company a percentage fee for the services it performs, and this fee is calculated on the average net asset value of the fund over a period of time.

The fee is regulated to an extent by the Ontario Securities Commission (OSC). An OSC policy statement provides for a maximum fee scale based on net assets administered, with the maximum of .75% on a fund of $100,000,000 or more. The .75% figure does not determine the entire compensation scale for a fund of $100,000,000, because the higher fees are permitted on the sums below that amount. Thus the management company may charge 2% on the first million dollars, 1¾% on the next two million dollars, and so on.

Sales charges are regulated by the exercise of discretion on the part of the OSC, with the Commission tending to deny the approval of a mutual fund prospectus where the fee exceeds 9%.

“"A STUDY OF THE CANADIAN MUTUAL FUNDS INDUSTRY""

The Canadian Mutual Funds Association commissioned Professors G. D. Quirin and W. R. Waters to conduct a study of the mutual fund industry, to

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7 The Report, supra note 1, at 45.
8 Id. at 319 for full text of the Securities Commission policy statement issued February, 1968. See also National Policy No. 7, infra.
A number of policies have been announced by the provincial securities administrators and by the Ontario Securities Commission since the publication of The Report. Some of the policy statements were formulated in response to issues raised by The Report.
A partial list of relevant policy statements dealing with mutual fund regulation follows:
Canadian Provincial Securities Administrators, National Policies, April, 1971:
National Policy No. 7, Mutual Funds: Management Fees.
National Policy No. 8, Mutual Funds—Computation of Net Asset Value Per Share.
National Policy No. 9, Mutual Funds—Forward Pricing, Sales And Redemptions.
National Policy No. 10, Mutual Funds—Redemption of Securities.
National Policy No. 11, Mutual Funds—Change of Management—Change In Investment Policies.
July 30, 1971:
National Policy No. 23, Mutual Funds — “In-House” Funds.
OSC Policies, April 5, 1971:
OSC Policy #3-06, Examination Program For Salesmen.
OSC Policy #3-07, Registration Of Part-Time Salesmen.
OSC Policy #3-11, Dual Licensing: Life Insurance Agents.
9 The Report, supra note 1 at 20, 40.
serve as a contribution or submission to those preparing *The Report*. The result was, *A Study of The Canadian Mutual Funds Industry.* Quirin and Waters present the rationale for the industry viewpoint with regard to the important issues pertaining to the regulation of mutual funds.

Quirin and Waters state their basic premise, that, given the ingredients of competition and free entry into an industry, the price paid by the purchaser will be the outcome of free competition amongst those offering the product. Free markets, predicated on the balancing action of supply and demand, result in the fairest prices. This is based on the assumption that people act in terms of their economic self-interest. The purchasing public may voice its opinion by refraining from purchasing a product which is overpriced. This is more efficient than the operation of government control, wherein the democracy of purchasers voting with their pocketbooks is replaced by government which acts arbitrarily. The government is sometimes influenced by a vocal minority which drives it in the direction of policies which upset this sensitive balance created by the forces of free competition interacting with the skeptical purchaser.11

The principal question to be determined is whether or not the mutual fund industry is governed by the genus of competition which will allow for the creation of the optimum price for the service provided. Quirin and Waters assert that "the greater the number of firms already in the industry and the greater the potential for entry, the less likely it is that existing firms can act in non-competitive (synonymous with undesirable) fashion. In particular, the less likely the possibility for control of supply and price."12

Quirin and Waters examined the concentration ratios for mutual fund management groups for a period from 1957-1967, and found that the trend of concentration was on the decline, and that therefore competitive forces are at work in the industry. "For example, the share of the largest management group dropped from 41.9 to 33.8 per cent while the share of the four largest groups dropped from 81.5 to 64.7 per cent and the share of the eight largest dropped from 95.3 to 78.7 per cent."13

It should be pointed out that these statistics bear out a high degree of concentration, despite a measure of attrition over the years. The fact that one management group accounts for 33.8 percent of the industry's assets, while the four largest include well over half of all the assets, represents a significant degree of concentration. Quirin and Waters admit that these levels are still above the standard desired by a prominent economist, for a competitive type of industry. But, they say, "the important fact in our view is that the concentration ratio has been dropping consistently over time."

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10 (Toronto: The Canadian Mutual Funds Association, 1969) [hereinafter *The Study*].

The Preface to *The Study*, at iv, indicates that it was financed by The Canadian Mutual Funds Association. At the same time, the preface by the CMFA Chairman of the Board, iii, explains that, while the authors Quirin and Waters received the views of individuals in the CMFA, they were free to reject them.

11 *Id.*, paper 2, at 1-3.

12 *Id.* at 4.

13 *Id.* at 8.
We may question whether it is appropriate to thus infer from the trend? The years covered, 1957-1967, represent one of the longest and most extensive bull-market periods in the entire history of the stock market. In an environment of growth, it is to be expected that the marginal organizations will gain in sales, at the expense of the proportionate share of the leaders. The test of the trend is what occurs in a long period of declining markets. We would assume that the larger management groups will retain a stronger proportionate share of the total industry assets, while a larger proportion of the attrition, stemming from the excess of redemptions over new sales of fund shares, will be suffered by the smaller funds. It would have indeed been more helpful if Quirin and Waters had related their statistics on trends of industry concentration to stock market trends.

To complete the picture of a mutual fund industry, characterized by healthy competition that will make for firms competing to give the purchaser the best and most reasonably priced product, we are told by Quirin and Waters that there is ‘ease of entry’ on the part of new firms, which can only enhance healthy competition. “The requirements for entry do not appear to be onerous; existing firms do not appear to have important cost advantages.”

However, it is important to distinguish between the ‘entry’ of entirely new management companies, and that of new mutual funds. The former is not as prevalent as the latter. Quirin and Waters fail to clarify this important distinction, and, in their discussion of ‘ease of entry’, it is not always clear whether the object is the mutual fund itself or the management organization. In the case of the 1957-1967 statistics regarding industry concentration, they are dealing with management organizations. They then go on to talk about the ‘ease of entry’ of ‘new firms’ and it isn’t apparent whether the mutual fund itself, or the management organization is meant. Later, they refer specifically to the small mutual fund, and say that it too can gain economies of scale in portfolio management and sales force administration, and then continue. “This is possible when the fund is operated as an appendage to an organization’s primary activity, as in the case of funds sponsored by some investment dealers and trust companies.” If the referent is the mutual fund, as opposed to the management organization, then ‘ease of entry’ proves little or nothing with regard to competition and concentration. This ‘ease of entry’ is restricted to existing mutual fund management organizations, and to other firmly established existing organizations with ample capital and resources, which can afford the risk, and can multiply mutual funds without too much difficulty. This however, is not the context for a truly competitive environment fostered by ‘ease of entry’! This is a peculiar ‘ease of entry’ restricted to a small select group of financial institutions, either mutual fund management companies, or those which function as management companies.

An examination of the new open-end funds that were either incorporated or commenced selling shares in 1968, will indicate that the bulk of these are represented by mutual funds spawned by well established existing mutual funds spawned by well established existing mutual funds.

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14 Id. at 14.
15 Id.
16 In the latter part of the discussion, Quirin and Waters refer to ease of entry in respect of management groups. The Study, supra note 10, paper 2, at 15.
fund management organizations, simply adding another fund to their stable of funds, or trust companies or stock brokerage houses using the facilities of their existing organization to finance and promote the new fund. These represent well established financial institutions, as opposed to those which could be described as independents starting from scratch. By examining the 1969 FP Survey of Investment Funds, and segregating those funds that were not mentioned in the 1968 FP Survey of Investment Funds, it appears that only 10 funds can be found which were either incorporated in 1968 or commenced share sales in 1968. Seven of these were organized by significant financial institutions, and three of these appear to be ‘independents’, though one cannot be certain that these do not also ‘belong’ to substantial financial institutions. The seven represented total assets of approximately $56,450,000, while the three represented only $1,500,000 in assets. It should be noted that the bulk of the $56,450,000 of the seven ‘appendage’ funds, comprises the $54,000,000 of The AGF Special Fund, which is merely an additional mutual fund started by the American Growth Fund Management Ltd., which ranked as the third largest Management Company in Canada in 1967.

Another aspect of the ‘ease of entry’ question should be examined. Frequently, the mutual fund distribution function is carried out by the management company, and even where the functions are separated and carried out by two entities, they are in effect, one. The U.S. SEC, in The Public Policy Implications of Investment Company Growth makes some important

18 The Study, supra note 10, paper 2, at 14. The FP Survey of Investment Funds, 1969, reports that the American Growth Fund had $311,900,000 in total assets.

The 7 funds started by well-established existing organizations are:
1. AGF Special Fund Ltd.
2. All-Canadian Revenue Growth.
3. I.O.S. Venture Fund Ltd.
4. Savings and Investment American Fund Ltd.

These four funds were started by existing mutual fund management companies already managing a number of well-established prominent funds.

5. Investoflex—which is really 3 different funds—the Equity; Income; and International Growth Fund. This is under the management of the International Trust Company, affiliated with the First National City Bank. This fund has since merged with another fund.

7. Mosslaw Growth Fund Ltd.

These last two funds are managed by stock brokerage firms.

The three ostensible independents are:
1. Abercorn Growth Fund.
2. Beacon Growth Fund.
3. Magma Carta Fund Ltd.

Uncertain:
1. Marlborough Fund. Appears that it is run by a management company which is, in effect, a securities firm.

Two additional funds which could have been included among the seven, but were not, because they are used by insurance companies for variable insurance plans:

These two for all intents and purposes should be viewed as mutual funds. However, we have not included them in our comparison.

revelations in the course of discussing the profit margins of the two entities. The management company, with its fee for advisory and other services, usually showed very substantial pre-tax profit margins, while, in most instances, by contrast, the margins of the distribution companies were very low, and many even operated at a loss. The Policy Report concludes that the management fee, in effect, subsidizes the sales operation, and that this works to the ultimate benefit of the large mutual fund organization, with the sizeable net asset value. "This practice tends to give the larger investment advisers a substantial advantage over the smaller ones in competition for sales of mutual fund shares."20

The Policy Report emphasizes the fact that the large fund, which generates substantial brokerage commissions, may use the commission to reciprocate, and reward with brokerage business the brokers who sell the fund's shares. It should be noted that, in effect, the minimum brokerage fees on large volume transactions up to $500,000 are excessive, because they are simply multiples of the 100 share board lot fee, and fail to make allowance for the fact that a 10,000 share trade generates little more expense for the broker than a 100 share trade.21 The excess brokerage is traded off for either services provided the mutual fund by the broker, such as research or net asset computation, or, in the form of rewards for selling the fund shares, which in effect, constitutes an additional sales commission. The large fund generates a large sum in commissions, so that, after paying for the services, there is, in the form of brokerage commissions, an ample sum to be viewed as 'reciprocal' payment, that is, payment to the broker of a bonus commission for selling the fund's shares. Therefore, The Policy Report concludes, "The use of brokerage commissions as compensation for sales of fund shares places small funds and small fund complexes at a distinct competitive disadvantage in connection with sales of fund shares."22 It is thus apparent that the large mutual fund organization can use its 'size' as a kind of 'muscle-power' to increase its net asset value, and reduce the prospect of serious competition from new entries in the field, offered by new management companies.

Quirin and Waters in their attempt to show that the mutual fund industry functions in a manner that is truly competitive, contend that the wide variety of 'acquisition costs' among the various funds, is an indicator of true competition.23 A large number of funds have no sales charge, and a few fall in the spectrum between the large number charging nothing, and the large number charging 8.5%. The Study proudly displays a chart, titled, "Distribution of Canadian Mutual Funds By Acquisition Charges, 1967", which shows

20 Id. at 125.
21 The Report, supra note 1, at 95-96, for a discussion of volume discounts. Since the publication of The Report, the NYSE and the TSE have adopted negotiated commission rates on the portion of transactions above $500,000. The effect of this move in the way of making volume discounts possible in certain transactions remains to be seen.
23 The Study's euphemisms reflect its viewpoint. Quirin and Waters are careful not to refer to them as 'sales charges' because that would create the impression that the 9% in its entirety goes to the distributor and salesman. This, of course, is the fact. Cf. The Report, supra note 1, at 39.
that almost 30 funds had a zero acquisition charge. Quirin and Waters proudly indicate that 36% of the newer funds had a zero acquisition fee.\(^{24}\) Indeed, a manifestation of massive competition in the mutual fund industry.

However, in another part of *The Study*, in connection with a different issue, Quirin and Waters speak disparagingly of the role played by the no-load mutual funds in the Canadian mutual fund industry. We are told,

Canadian funds with zero acquisition charge account for only a small proportion of the assets of Canadian funds — less than 6 percent at the end of 1967... Between 1962 and 1967, the size of the industry almost tripled and presumably investor awareness of funds' existence increased also. Viewed in this light, the increase in the market share between 1962 and 1967 of the zero acquisition charge group appears quite modest.\(^{25}\)

It appears that between Paper 2 and Paper 7, the much vaunted competition all but disappeared! The desire on the part of the authors of *The Study* to have it both ways, explains the fallacy in their statistics as to a wide distribution of sales charges. This variety of sales charges exists only when we look at numbers of funds. However, when we examine distribution of asset value, the opposite conclusion becomes apparent. The asset value is by far the more significant figure, because that indicates the sales charge being paid on behalf of the largest sum or total of investors' money. In reality, the basic and representative sales charge rate is between 8 and 9 percent of the total paid, the latter being the highest rate. Those who charge this basic rate represent 61.9% of the number of funds. But, they represent 91.8% of the dollar amount of all mutual funds.\(^{26}\) This figure illustrates the fact that the funds charging less than 8% have remained the smaller ones. If Quirin and Waters are indeed correct, in their assumption as to the prevalence of true competition in the Mutual Fund industry, we would believe the reverse to be the case. That is, the mutual funds that charge the least would grow at the expense of those who 'overcharge'. It should be noted that the mutual funds have not limited themselves to a maximum of 9% because of charitable impulses or considerations of competition, but because of the exercise of discretion on the part of securities administrators who would not accept prospectuses with higher sales charges.\(^{27}\)

The mutual fund industry is indeed characterized by competition, but not the type that would tend to bring sales charges down to reasonable levels. On the contrary, the competitive force is exerted by the brokers and sales organizations, that is, those who sell the fund shares, to increase the sales charge. They concentrate on selling the particular fund or funds which pays

\(^{24}\) *The Study*, supra note 10, paper 2, at 21; and chart at 20.

\(^{25}\) Id. paper 7, at 4. Cf. paper 2, at 21, note 23, where Quirin and Waters attempt to reconcile the contradiction in employing the no-load fund statistics to derive two contradictory conclusions.

\(^{26}\) *The Report*, supra note 1, at 48.

\(^{27}\) Id. at 20, 40, re the role of the securities administrators and the exercise of their discretionary powers to reject higher sales charges. It appears that 9% has been accepted as the top rate, generally, in the U.S. almost as if by custom. The 9% maximum is the only sales charge maximum specification in the U.S. Investment Company Act, 1940, and it is with reference to Periodic Payment Plans (Front end loads) in sec.27(1).
them the highest sales commission. The Policy Report, discussing the competitive pressures on sales loads, says,

Differences in the compensation paid to retail sellers of fund shares play a most important part in the competition for sales. During the past 16 years, competition for dealer favor has exerted significant upward pressures on the general level of mutual fund sales loads. The Policy Report, in citing the landmark study, The Wharton Study for its conclusion that the higher the sales load, the larger the fund, or the fund complex, quotes The Wharton Study, which says that "... many of the larger (mutual fund) systems ... have found that high retail commissions, which induce greater selling effort, tend to increase the rate of sales of investment company shares." This is borne out by the Canadian fund statistics cited above, and noted by Quirin and Waters, to the effect that the funds with the lower or zero sales charges have not grown as much as those with the conventionally high sales charges.

Quirin and Waters attempt to justify the sales charges of mutual funds, which are considered by the U.S. SEC to be inordinately high when considered in the light of sales commissions in the securities industry generally. We are concerned with those on lump-sum or voluntary purchases, as opposed to the 'contractual plan'.

What Quirin and Waters fail to discuss, is frequently more significant than what they choose to analyze. With all of the statistics and figures analyzed in The Study, it is surprising to find no comparison between the sales charges of mutual funds, and those for stocks listed on the Exchanges or traded in the over-the-counter markets. There is no reference to the sections in the SEC publications, where exhaustive comparisons are made between the commission schedules for various securities on the one hand, and mutual fund sales charges on the other hand. The Study fails to refer to the comprehensive and convincing data, showing that mutual fund sales charges are the highest in the securities industry, with absolutely no justification in terms of the valid overhead costs, or the services provided the investor in return for the sales fee.

In an extensive statement presented before a Congressional Committee, Manuel Cohen, the former SEC Chairman, documented the fact that the mutual fund industry extracts the highest sales charges in the securities industry. It should be noted, regarding comparisons with securities transactions executed on the New York Stock Exchange, that these minimum commission schedules are roughly comparable with the Toronto Stock Exchange rates. While the vast majority of the significantly large mutual fund sales charges cluster around the 8.5% level, Cohen concludes that mutual fund sales charges are in many instances, nine times as much as those involved

28 Id. at 48.
30 A Study of Mutual Funds, prepared for the SEC by the Wharton School of Finance and Commerce, 1962 [hereinafter The Wharton Study].
32 E.g., id. at 209; "D. Comparison of Mutual Fund Sales Loads With Costs of Other Securities Transactions."
in investing in individual securities of comparable quality. A 'round trip' trade
of a $38.00 security, which is comparable to the benefit derived from the
mutual fund fee because it covers an 'in and out' transaction, is approximately
2% on the NYSE.\textsuperscript{33}

\textit{The Policy Report} indicates that the sales charge on $4,000 invested
in a mutual fund is over 4 and 3/4 times the 'round trip' NYSE commission.\textsuperscript{34} \textit{The Policy Report} also explains that the disparity is even greater, when we
consider the fact that the mutual fund purchaser is also paying the brokerage
fees as a hidden charge for the trading of the portfolio securities comprising
the mutual fund shares. Furthermore, it should be recalled, as mentioned
above,\textsuperscript{35} that these brokerage charges frequently represent additional sales
compensation, because they are often employed to reward brokers who sell
the fund shares.

\textit{The Policy Report}, in assessing the mutual fund industry's defense of
its sales charge structure, says, "Secondly, in comparing mutual fund sales
charges to the charges for buying and selling other securities, they assume that
a mutual fund investor who wishes to sell his shares needs the services of a
broker-dealer to find a buyer." This is not the case, because the mutual fund
itself redeems the shares, whereas the stock broker does perform a significant
function, in that the floor broker, or over-the-counter trader must find some-
boby to act on the other side of the transaction.\textsuperscript{36}

The securities underwriter, who acts as a principal, usually takes about
4% of the proceeds, less than half of the 8.5% of the mutual fund dealer.
When calculated the same way for the mutual fund purchaser as for the pur-
chaser of an underwritten security the mutual fund dealer realizes a 9.3%
share of the proceeds. The underwriter, who acts as a principal, is indeed
earning his fee, because he must make an intensive effort to distribute the
stock within a limited time or period, and if he fails to distribute his allot-
ment, he must keep the shares as inventory on his shelves, with attendant
interest costs, plus the risk of decline if the market turns down, not to speak
of loss of reputation if he is a member of a selling group and fails to sell his
allotment. The mutual fund 'underwriter' or distributor assumes no compar-
able risk in his operations, yet charges the purchaser more than twice as
much as what the securities underwriter charges.

It is unfortunate that Quirin and Waters fail to direct their attention to
the above mentioned comparisons. Let us examine their rationale for the
mutual fund sales charges, which appear to be extremely high when viewed
in the context of the securities industry, and against a background of services
rendered. Quirin and Waters discuss the alternative to mutual funds as being

\textsuperscript{33} \textit{Investment Company Act Amendments of 1967, Part I,} Hearings Before The
Subcommittee On Commerce and Finance of the Committee On Interstate And Foreign
Commerce, House of Representatives, Ninetieth Congress, 1st Session, at 50, 51.

\textsuperscript{34} \textit{The Policy Report, supra} note 19, at 211.

\textsuperscript{35} \textit{Id.}

\textsuperscript{36} \textit{Id.}
"Do-It-Yourself Portfolio Management" and conclude that this is a costly procedure. It entails an expenditure of time on the part of the investor, and time is money. This, they explain, is in addition to the costs of periodicals and investment services. It would be appropriate to mention that some of the best investment publications are obtainable without cost, such as, for example, bank letters, which discuss trends in money supply and their relationship to stock prices, economic trends and profit margins. Annual reports are obtainable without cost from publicly traded companies. Stock brokers too, offer statistical materials and company and industry studies, at no extra charge, all for the approximately 1% brokerage fee.

It is misleading to discuss the cost of managing one's own portfolio within the context of an attempt to rationalize mutual fund sales charges. These sales charges are generally unrelated to the mutual fund management function, which is portfolio selection and diversification of investments. The sales organization and the salesman benefit from this fee. This approach, however, is consistent with the impression that mutual funds strive to convey, to the effect that through some mystical process, the high sales charge is related to the performance of the fund in a positive way.

The Quirin and Waters' contention that the 'do it yourself' investment portfolio entails costs that are considerably more burdensome than those involved in mutual fund investment, should be approached with a degree of skepticism from the vantage point of the demands made on the investor who would attempt to select the mutual fund most suitable for his needs. With the plethora of mutual funds, with their varying features and conditions as outlined in the prospectuses, and different performance in different types of markets, the time and effort involved in researching and selecting a fund, represent a real cost. Constant surveillance is necessary, because the investor's financial considerations may change, as may the fund's performance and management. This year's star performer may turn out to be next year's laggard. The alert mutual fund investor must be prepared to make a significant expenditure of time, in order to choose and to monitor his mutual fund, and as Quirin and Waters contend, time is equivalent to an expenditure of money.

While Quirin and Waters have an affinity for numbers and statistics, they somehow omit mention of the crucial figures, which might convey something of the actual configuration of the sales fee and its relationship to the management fee. The latter comprises the only contribution, a part of which goes to provision for advisory service and portfolio management. The relevant figures follow. When one purchases mutual fund shares for $1000.00 with a sales load of 8.5%, the dollar figure for the sales load is $85.00, and $915.00 is the actual amount which goes into the investment pool. Assuming brokerage fees for the investment of that particular sum of money into common stocks, at regular round lot prices, the commission is, at 1%, $9.15, which means that, in round figures the actual investment of portfolio securities represented by that $1,000.00 mutual fund purchase is $905.00. The management fee,

37 The Study, supra note 10, paper 7, at 8, 9; paper 4, at 1, 2, 22.
assuming a charge of .50%, is approximately $4.57. The $4.57 sum is the only one which provides for investment management, as opposed to the $85.00 sales charge. Assuming a level net asset value, the single acquisition sales charge, is equivalent to more than seventeen years of management fees. This will convey some idea of the extent to which the extremely large sales charge, dwarfs, by comparison, the management fee which represents the only moneys which are being paid by the investor for the carrying out of the portfolio management function. It is thus grossly misleading to justify the extremely high sales charge, by relating it to the cost of 'do-it-yourself' investing.

Quirin and Waters offer additional ex post facto rationalizations for a generous level of sales charges. The mutual fund salesman makes an important contribution to the purchaser in the provision of guidance, investment counsel and servicing. The sales charge also pays for the advice the salesman offers the purchaser on income tax advantages with regard to his investments, "and the role of investments in estate planning." The SEC Report of Special Study of Securities Markets, discusses the damage done by mutual fund salesmen who distribute legal forms, without advising their clients of the need to consult a lawyer.

Quirin and Waters contend that a C.M.F.A. (Canadian Mutual Funds Association) study shows that the salesmen made "an average of 2.7 contacts totalling 4.1 hours with lump sum purchasers prior to purchase", and salesmen reported "an annual average of 3.2 after-purchase contacts totalling 3.5 hours." We may question the value to the purchaser of the time thus spent, and Quirin and Waters concede that many of the additional contacts were for the sake of inducing new sales. The Report however, tells a somewhat different story, when it indicates that "in approximately half of all cases the sale was made in a single visit." This does not compare with an average of 2.7 contacts prior to purchase. If this were the case, then the 'approximately half' who required more than one visit, would require an inordinately large number of visits, to bring the average up to 2.7. It might indicate, if the other half indeed required almost five visits, that these were cases where salesmen had to alter their sales tactics to persuade those who may have good reason, in their circumstance, not to invest in mutual funds.

Quirin and Waters avoid making the pertinent comparisons between mutual fund sales charges and those of other securities, thereby enabling them to evade the relevant consideration of a comparison between what the securities broker offers for his approximately 2% commission as opposed to what the mutual fund salesman offers, and the relative costs of each. It is important to consider, with reference to costs, that much is made of the fact that the investor in mutual funds need not be concerned with stock certificates and

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39 Cf. id. at 52, 53, and at 53 note 129.
40 The Study, supra note 10, paper 7, at 2-6.
41 Id. paper 6, at 1.
43 The Study, supra note 10, paper 7, at 6.
44 The Report, supra note 1, at 53; also at 509.
other bookkeeping. The authors of The Study do mention that in the case of contractual plans, custodial fees are charged, for safekeeping and record keeping. The administrative and safekeeping duties performed by the funds, are not paid for by the sales charge. They are derived from the management fee, and in some cases are an extra charge on the mutual fund assets. Quirin and Waters do not discuss the fact that stockbrokers provide safekeeping for a client's securities, notify him of rights that must be exercised, collect dividends for him, all at no extra charge, but as part of the service provided by the original 1% brokerage fee on the purchase of the shares, and the possible, but not necessary assumption that the client will sell the securities through the facilities of the stockbroker.

As to service, the stockbroker provides a far more extensive and continuous service for the investor, beyond the point of the sale, than does the mutual fund salesman. The broker stands ready to provide stock market information and quotations on a daily basis. He provides investment advice at critical turning points in the market, and is buttressed, in many instances by an extensive research department, sometimes augmented by economists. As an example, of a service which is indeed commendable, the analysts of stockbrokers, Mills, Spence & Co. pored over the November 1969 White Paper on Tax Reform for an entire weekend following the Friday night release of the proposals, so that their clients would receive, in the Monday morning mail, a twenty-eight page comprehensive report on the investment implications of the proposals! All of this, for 1% or 2% and not 9.3%.45

Quirin and Waters develop additional questionable arguments to indicate not only justification for the currently high sales charges, but to prepare the ground for increases. As the mutual fund sales begin to saturate a good deal of the population, they may reach the same plateau that has characterized the life insurance market recently. And that represents a kind of maturity where a large number of individuals already hold mutual fund shares, and thus more effort will be required to effect a sale. Therefore, the mutual fund industry will be constrained to consider the possibility of raising 'acquisition charges' so that they more closely approach the higher fees characteristic of the life insurance industry.

Quirin and Waters warn against introducing regulations which would preclude such an increase in sales charges which may very well be required in the future.46 They express concern about this matter, because they want the level of compensation to be high enough so as to attract salesmen to the mutual fund industry as opposed to other sales careers.

45 Original Mills Spence Report, dated November 9, 1969, and a 15 page “Follow-up” dated November 9, 1969. Quirin and Waters refer, almost as an aside, to “the advice of a security brokerage dealer's customer's man” as being ‘free’ “only because the commission charged on the sale or purchase of securities is high enough to cover the cost of effecting the transaction and providing the advice.” The Study, supra note 10, paper 4, at 1. They fail however to deal with this in terms of the relationship between brokerage charges for securities transactions on the one hand, and sales charges of mutual funds, on the other hand; together with a comparison of the services rendered in each of the two instances.

46 The Study, supra note 10, paper 5, at 9, 10.
In analyzing statistics on mutual fund salesmen's wages, Quirin and Waters bemoan the fact that 58% of those surveyed were in the under $2000 per annum class, with only 11.2% receiving more than $10,000. They compare the mutual fund salesmen's earnings with those of other salesmen such as securities salesmen and real estate brokers. "Because of the similarity of the background and training for all of these classifications, (this would include securities salesmen) we would expect their levels of remuneration to be quite similar." While acknowledging factors which would make for lack of comparability in income, the authors refer to the fact that the "mean values" of employment income for securities salesmen were higher than for mutual fund salesmen.\(^{47}\)

We would seriously question the assertion that the training of securities salesmen is in any respect comparable to that of mutual fund salesmen. Securities salesmen are subject to far higher standards than are the fund salesmen. The stockbrokers of TSE member firms must pass the Investment Dealers Association sponsored Canadian Securities Course, which includes lectures in addition to written work, and a final examination.\(^{48}\) Many Canadian brokers are also subject to the U.S. regulations, and must pass an examination administered by the U.S. N.A.S.D., which includes an extensive section relating to the NYSE. Thus, it is not entirely fair to compare the two sales categories, because there is a great disparity in the educational requirements.\(^{49}\) It may be suggested that perhaps the low income levels of mutual fund salesmen is attributable to inefficiency in training salesmen, and in hiring or 'overhiring' salesmen. The investing public should not be expected to compensate the industry for its lack of efficiency. It should be noted that to raise the income level of the large $2000 per annum class, to let us say, double, together with increasing the other levels, would apparently require at least a doubling of the currently over generous sales commission, to approximately 19%. Is this what Quirin and Waters mean to suggest?

*The Study* emphasizes that the salesman indeed performs a most useful function, because he brings mutual funds to the attention of those who require them for their investment portfolios. And, this is an important service, which cannot be provided without cost. *The Study* praises the minority of economists who recognize the importance of selling costs. They explain that "we must be prepared to accept the cost of providing salesmen to carry to the individual information about his insurance and savings requirements, or let those requirements go unsatisfied." This assumes a generally ignorant investing public, which is simply unaware of the existence of mutual funds, and

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\(^{47}\) *Id.* paper 8, at 7, 8.

\(^{48}\) J. C. Ballie, *The Protection of the Investor In Ontario*, 8 Canadian Public Administration, No. 3 at 325, 422, where he describes the examination of the Canadian Securities Course as "an efficient device to screen out applicants not prepared to expend the necessary effort to learn about the business." * Cf. fn. 641, where "a failure rate of about 21 percent" is indicated. * Cf. infra, p. 652, for discussion of the CMFA examination for mutual fund sales candidates and the fact that *The Report* provides no figures on the failure rate.

\(^{49}\) *Cf. infra*, p. 650 for a discussion of the very minimal requirements for mutual fund salesmen.
requires salesmen to effect the revelation of this “mystical secret” known as the mutual fund.50

But, this view does not appear to be consistent with that of another paper in The Study, where the authors refer to the sophistication and knowledgeability of the mutual fund investing public. They tell us that mutual fund investors, as a group are well-informed customers, because they flock, in droves, to the most superior product. That is attested to by a relationship between inflow of funds and rate of return. There is a relationship, the authors contend, after performing gyrations with higher mathematical formulas, between performance of a fund and the level of sales.

Firstly, if investors are sufficiently adept to put their money into the funds that are showing the best rate of return, one would think they could find out about mutual funds by means of their own resources. One cannot attribute this selection process, contended for by Quirin and Waters to edification by salesmen, because many of the largest Canadian funds sell through ‘captive’ sales forces,61 comprised of salesmen who offer only the ‘house’ funds, for better or for worse, without inculcating in their clients a sensitivity to comparison shopping as to performance and rate of return. Secondly, we have, above, cited from the mutual fund studies which indicate that the principal determinant of fund size is the sales charge, with those offering a higher sales ‘bite’ gaining more adherents from among the salesmen and brokers.

In rationalizing the sales charge, Quirin and Waters attempt to demonstrate a great need for the function that the salesmen perform. They say,

If everyone had perfect, or even equal knowledge of the future performance of securities available in the market, there would be no need for professional investment management any more than there would be a need for medical practitioners (other than surgeons) in a world in which everyone had equal knowledge of the implications of his own symptoms and the efficacy of all available drugs.52

The identification of the treatment by a doctor, with the advice of a mutual fund salesman is misleading. This is because medical knowledge is so specialized that a medical student, after his first week of classes in the first year of medical school, cannot treat or diagnose an illness, while a mutual fund salesman will sell mutual fund shares as early as the first week he is engaged by a sales organization.53

THE CONTRACTUAL PLAN

The contractual plan raised some doubt as to the legitimacy of certain sales charges. The Report aptly defines this type of plan as “any periodic payment plan for the purchase of mutual fund shares or units under which the amount deducted for sales charges from payments made during an initial period is greater than it would be if the same total amount of sales charges were evenly deducted throughout the life of the plan.”54 Contractual plans are

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50 The Study, supra note 10, paper 3, at 3, 4.
51 The Report, supra note 1, at 33.
52 The Study, supra note 10, paper 5, at 4.
53 Cf. infra, p. 653.
54 The Report, supra note 1, at 360.
divided into those where the entire initial payment constitutes the sales charge, as in the prepaid sales charge plan, or where a disproportionate amount of commission is carried by the initial payments, as in the traditional contractual plan. Quirin and Waters set out to promote the most extreme version of this advance commission payment scheme, the prepaid sales charge plan. This is where the entire first payment consists of commission, with no part of it going towards the acquisition of underlying shares. A portion of this down-payment is credited to the subsequent payments as the portion representing commission. It should be noted that these shares are purchased from a 'plan sponsor' company which acts as an intermediary between the purchaser and the mutual fund, and charges a service fee for its bookkeeping expenses. The authors suggest that the average charges over the life of such a plan, in the case of a $20.00 minimum payment plan, would be, in round figures 12%.

While we have distinguished between the two types of 'contractual' plans, Quirin and Waters seem to lump them together, and refer to them under a general category of 'prepaid sales charge plans', without distinguishing between the case where the entire initial charge is commission, or where a portion, usually about fifty percent represents such a charge. The authors appear to be very careful not to employ the term 'front-end load' plan. Perhaps this designation would tend to indicate too clearly the preponderance of commission which is deducted from the first year's payments.

The authors attempt to prove that despite the effect of the prepaid sales charge and the service charge, the disparity between the 'contractual' plan and the "pay as you go" (we would call it the 'level-load') in terms of rate of return is not as great as one might think, given an allowance for the passage of time. While the contractual plan rate of return will never equal the 'level-load' plan of return, the gap is narrowed considerably after ten years of payments. It should be stressed that Quirin and Waters are assuming a 10.7% portfolio return as the medium for nullifying, to an extent, the effect of the heavy sales and service charges. In the example used in the authors' tables, it would take four years for the rate of return to equalize the effect of the sales and service charges. For example, in the first year, the return is a negative figure of 70%; the second—21.7% and so on, and by the fifth year, a positive figure of 2.7% is achieved. The authors claim, in comparing the yield as between the contractual and the level load investment, that, "The extent to which yield is sacrificed is negligible if any substantial time period is considered, as comparison of realized rates of return over 10 to 20 year periods indicate."

First, we may question the assumption of a 10.7% annual rate of return. That figure is based on "the mean portfolio yield over the period 1960-65" of 34 Canadian funds. Aside from the fact that one ought not project yield for twenty years in the future, on the basis of a five year period, the period chosen, marking an extensive Bull-Market trend, is indeed a biased one. One need only examine the record of mutual fund performance for 1969, when many of the prominent mutual funds lost from 10% to 35% of their

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56 Id. at 16.
57 Id. at 13.
value to learn that a one year period may reveal a less profitable market result. This fact should be evaluated against the background of the negative return during the first four years of the operation of such plans. And, even the five year performance records, showed a number of minus signs, while the plus signs were not followed by significant gains. The gains, in most instances were not of the order of 10.7% per annum.\(^{58}\)

Even admitting the validity of the long term projections, which may indeed be questioned in terms of future periods which may bring a radically different investment climate, they should be viewed against a background of the record of actual investor practise with regard to these 'contractual' funds.

The erratic nature of the security markets, plus the inordinately high level of sales charges on the initial payments, mean that the investor who redeems prior to the completion of the plan, stands to suffer a severe penalty. He will absorb the commission charges on the 'unpurchased shares' as well as the loss resulting from any short term market reaction. Even according to the Quirin and Waters' figures, he will be a net loser if he redeems within the first four years of a contractual plan. And, assuming a rising market, he will not gain the full benefit from the attendant appreciation because the disproportionate sales charge has reduced the portion of his investment which is actually working for him in the marketplace. The authors' justification for such plans on the basis of 10 and 20 year projections, is nothing short of utopian, given the statistics of early redemption and non-completion of plans, and even an elementary knowledge of the steadfastness of long term investment programs where the demands on the family income have reached and are continuing to reach astronomical proportions. The evidence regarding the large number of early redemptions of these contractual 'shares' even in the first year, and failure to complete the plans, has been well-documented by the American sources and by *The Report*. These sources also reveal investor ignorance as to the negative financial consequences of early redemption and failure to complete a plan.\(^{60}\) It appears strange that these pertinent sources are not tapped by authors who appear to be committed to finding out what actually occurs in the industry.

It is not difficult to understand why *The Report* contends that the investor stands to lose upon adopting such a plan, while the principal beneficiary is bound to be the salesman.\(^{60}\) Quirin and Waters, however, believe that what is good for the salesman is good for everybody.

The prepaid sales charge provides the funds from which the salesman receives the bulk of his compensation in respect to that sale. Providing the bulk of his compensation at this stage recognizes the fact that the bulk of his work is performed to seek out the would-be client and to effect a sale.\(^{61}\)

It is indeed strange that the same authors who justify the extravagant normal sales charge by presenting statistics in respect of the service provided

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\(^{60}\) *The Report*, *supra* note 1, at 362.

\(^{61}\) *The Study*, *supra* note 10, paper 5, at 6.
the client by the salesmen who are reputedly versatile tax experts and estate-planners, will at the same time contend that the salesman who sells a contractual plan should be paid commission from currently uninvested funds, because he has already performed his service with the conclusion of the sale. Why do Quirin and Waters in this context, dispense with 'service' as a justification for commission charges, and, in effect, deny it? In the case of the contractual plan, follow up servicing on the part of the salesman is more relevant than in the case of the sale of a 'level-load' fund, because the salesman ought to educate his client to maintain his payments, so that he will not be penalized after paying the higher commissions on the initial payments during the first year. The answer is very simple. Quirin and Waters realize that the salesmen do not wish to service such an account, because they have already collected the bulk of their commission in the early stages of the plan's operation, and there is little motive for them to return, once they have extracted the exorbitant prepaid commissions from the client.

The authors then try to show that the 'contractual plan' must be a good thing because other fine reputable industries promote it, such as life insurance, where the bulk of commission is subtracted from the first year's premium. It is interesting that in this particular instance, the authors acknowledge an argument developed by the S.E.C., and refer to the Public Policy Report, in a footnote. The Policy Report suggests the distinction that in the case of insurance, the purchaser receives the immediate benefit of 'protection' in the event of death, to the extent of the full amount of the policy. The authors are satisfied to mention this point, because they cite The Policy Report's admission that the greater part of the premium represents the savings portion and not the protection cost. We may then summarize the authors' argument as being that if the life insurance industry misrepresents its policies to the clients, so that they accept a very low return on their savings portion of the insurance, which is larger than they are led to believe, it is therefore perfectly acceptable for the mutual fund industry to insist on being allowed the luxury of a similar type of misrepresentation.

Quirin and Waters then employ a most surprising argument when they say that "The purchase of a house partially financed by a mortgage involves transactions costs which have an effect similar to prepaid sales charges." Even aside from the authors' reluctance to calculate realized returns, such as rent, the comparison appears to be imprecise. Firstly, in the case of the home, the purchaser enjoys the full value of the entity he is purchasing, in contrast to the 'front-end loan' plan, where the purchaser enjoys the investment benefit of a small portion of the money he has already paid. Secondly, and more important, one need not be an economist to realize that shelter, a home, is a basic necessity. Investment in mutual funds can only be described as a function of discretionary income, or that which is left over after paying for necessities.

These funds may never be invested, (funds in the sense of money on which or for which advance commission has been paid) and the odds are that in most cases they will not be invested, on the basis of the sources cited above, note 59. The Study, supra note 10, paper 5, at 7, note 7. Id. at 22.
sities such as food and shelter; but is not something to be acquired by means of borrowing, and incurring interest costs, etc. Perhaps Quirin and Waters are, in reality, saying that a salesman who is sufficiently glib to obliterate this distinction in the mind of the prospective investor, indeed deserves to be paid a substantial commission, and in advance!

The authors fail to confront the massive evidence referred to above which indicates the large percentage of contractual plan investors who discontinue the plans and redeem prematurely. Instead, they contend that the salesmen try to evaluate the purchaser's ability to complete a plan. The evidence gathered by the S.E.C.'s Special Study of the Securities Markets indicates to the contrary, and there is no reason to believe that Canadian salesmen, in the absence of any significant restraints on their activities, would tend to be more careful or more restrained in their sales efforts, than their American counterparts.

Following the above assertion, Quirin and Waters say that despite the salesman's care in assessing the potential purchaser's ability to compete, it is inevitable that some will be constrained to redeem, prematurely, and will thus suffer loss. But, they suggest that such an eventuality is not as serious as it might seem, because of the following:

Given the omnipresence of sales representatives for other assets, many individuals having to discontinue mutual fund contractual plans prematurely would, in the absence of such plans, have acquired alternative assets on which the acquisition charges and resultant loss would have been even greater.65

This suggests that, since the 'gullible client' might have spent the funds on a defective used car, or may have been deprived of his funds by means of some other deceptive practice, we, the sellers of 'front-end' load funds, are performing a significant service, because, although he may pay an exorbitant price, he is nevertheless left with something to redeem. This is a dubious recommendation for an industry which purports to provide investments characterized by security and stability.

MANAGEMENT FEES

To understand the locus of the problem with regard to the regulation of management fees, it is essential to again refer to the structure of mutual fund companies. It has been explained above66 that Canadian mutual funds are externally managed, which means that a management company organizes a separate entity, the mutual fund. The mutual fund then enters into a contractual relationship with the management company, whereby the latter provides investment advice, and frequently administrative services, in exchange for a management fee, which is usually approximately .50% per annum calculated on the average value of the mutual fund's net asset value. The distribution company, the sales outlet, is often a branch of the management company, or is incorporated as a separate entity. Some management companies have organized a number of mutual funds, each directed towards a different investment objective, and some also provide investment advisory

65 Id. at 29.
66 Supra, p. 601.
services for institutions such as pension funds, or for sizeable individual accounts. In contrast to Canadian funds, a number of American funds, some very sizeable, such as the M.I.T. Fund, are internally managed, which means that the Mutual Fund and the management company operate under one corporate roof.  

The management company, because it has given birth to the mutual fund, believes that it therefore enjoys a total proprietary interest in the Fund, and may 'operate' it as it wishes. In this view shareholders in mutual funds are not 'shareholders' in the corporate sense, with a voice in the affairs of the fund, but are merely individuals who have conveyed their money to the fund to be managed by a management company in which they have confidence. A second view, which is the most tenable from the pragmatic perspective of investor protection, is that the mutual fund, following its creation, is an entity separate from the management company, which ought to bargain at arm's length with such company to obtain the best contractual terms conceivable with the management company. The management company should serve the best interests of the mutual fund, instead of allowing the mutual fund to be viewed as a mere appendix of the management company without a voice with which to express its own self-interest.

If the first view holds, then there is no reason for a mutual fund to have a Board of Directors at all, let alone an independent Board, to scrutinize and oversee the fund's relationship with the management company. Despite the corporate or organizational form, the mutual fund is a mere satellite of the management company. In the second view, since origins do not determine present relations, the mutual fund is, in reality, an entity independent from the management company, which purchases various services from that company, and does so only on terms which are most advantageous to the mutual fund; that is, only for so long as the management company performs its services to the reasonable satisfaction of the Mutual Fund Board, which acts as a 'watchdog' in overseeing the way in which the management company performs its functions. The efficient and effective functioning of an independent Board of directors is one of the best guarantees that the investor will receive the fairest return for the investment advisory and administrative expenditure paid out for him by the mutual fund. This is the approach which will most likely insure that management companies retain a competitive stance, and operate with adequate expertise and at reasonable cost, so as to retain the allegiance of the independent members of the Mutual Fund Board of Directors. As long, however, as the management company may view the mutual fund as a dependent 'dog' tightly tethered to it with no place else to go, then there is no competition, regardless of how many of these mutual fund complexes come into existence every year.

Since Quirin and Waters adopt the tethered dog theory of the relationship between a mutual fund company and the management company, their
discussion of 'competition' in the industry that is said to guarantee a wide variety of options to the fund purchaser, is not convincing. Yet, they continue to weave their hypotheses around an illusory competition, which is difficult to detect. Quirin and Waters contend that management fees "were determined primarily by competitive pressures, and that they tended to cluster around 1/2 of 1 percent of net asset value, as they do in the U.S. as well." It is somewhat paradoxical to find that there is competition as to management fees, but that they all happen to cluster around 1/2 of 1%. If true competition obtained, the result would be a wide range of management fees. Presently, there are few funds charging less than 1/2 of 1 per cent.

Quirin and Waters explain that in the case of "a competitive economy, with effective competition between alternative management companies, economic theory predicts that the management fee will be forced to a level related to the marginal cost of providing the service..." If this is so, one wonders, in view of the authors' position that shareholders have nothing more than 'depositor' status in a fund which is effectively controlled by the management company, how effective competition could ever exist as between alternative management companies? If the mutual fund is a mere puppet of the management company, why must the latter compete with anyone?

Quirin and Waters in justifying a position that the management fee not be regulated, suggest the extent of the financial requirements for providing adequate investment advice, in that security analysts and portfolio managers, etc. would have to be provided from the proceeds of the advisory service fee. However, in this crucial area, Quirin and Waters fail to provide us with any analysis as to the actual expenditures of management companies for personnel who generate the investment counsel, in relation to what they receive in advisory fees. Yet, they conclude that, "We are more concerned with the possibility that the competitive level of management fees is inadequate to support first-class portfolio management than with the possibility of excessive fees." They go on to explain that the control over management fees on the part of securities administrators, "is bound to discourage innovators who might provide more intensive and expensive management and which might provide more than commensurate benefits to fund shareholders." How can they make such a statement, when they present no evidence as to the percentage of the current management fee which is expended on improving the research service, and the percentage which goes to enhancement of

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70 The Study, supra note 10, paper 1, at 10, 14, 15.
Cf. supra pp. 604-609 for a discussion of the Quirin and Waters contention that competition rules in the mutual fund industry.

71 The Study, supra note 10, paper 10, at 2.
72 As to the wide variety of management costs, it should be noted, for example, that the internally managed M.I.T. fund reported an expense ratio as low as .18%, for 1965. The Policy Report, supra note 19, at 103. It should be appreciated that a small fraction of a percent will represent a large sum of money in the case of a mutual fund with assets totalling hundreds of millions of dollars.

73 The Study, supra note 10, paper 10, at 2, 3.
74 Id. paper 1, at 14.
75 Id. paper 10, at 4.
76 Id. paper 10, at 6.
the management company’s profit margin? On what basis do they exude such confidence that any extra charges for management fees will be translated into improvement of the investment advisory research function? It is, in fact, possible for a management company which is a division of or an affiliate of a stock brokerage firm, to carry out the investment management function, with little or no outside investment advisory expense over and above the normal research department service provided by a brokerage firm.77

It is also possible for a management company to provide investment counsel to a mutual fund, for example, of $20,000,000 for little more than a basic expense of $75,000, which is the cost of a statistical service on U.S. and Canadian stocks, such as The Canadian Business Service, which makes specific Buy and Sell recommendations based on security analysis principles. The only other requirement may be a security analyst or stock trader, for a cost of about $10,000.00 per year. The investment advisory fee, at 1/2 of 1% would be $100,000.

Quirin and Waters reveal their awareness of the fact that management companies receive research reports and advice from brokerage firms, but that this too requires an adequate staff to evaluate the various recommendations and reports which are sent by brokers regarding securities.78 Here too, the crucial question is whether they in fact do spend the advisory fee income to provide an adequate staff to evaluate incoming research studies?

The authors also discuss the economies of scale in investment management, that is, to the effect that one management company can manage a portfolio twice its current size, for example, at very little additional expense. However, it indicates that many Canadian funds have not reached the size where economies of scale are a relevant factor.79 Yet, the economy of scale, should be a factor which would justify an expectation that the management companies of large funds ought to share the benefits of this economy with the mutual fund shareholders.80

Despite their recognition of this factor, Quirin and Waters make no recommendation that this should be a consideration in the setting of fees, and that a sliding scale should be instituted, among the larger funds, to ensure that the mutual fund purchaser is not overcharged. Instead, one of the essential recommendations is that “management and administration fees remain free to move to those levels dictated by competitive forces.”81 Since these competitive forces do not exist, it essentially means that a management company may organize a fund, and charge whatever fee it pleases, subject to no controls on the part of government, on the part of the Mutual Fund Board of Directors, or on the part of shareholders; with the exception of the suggestion

77 The “Martin Report”, commissioned by the NYSE, proposes that brokerage firms divest themselves of their mutual-fund subsidiaries and thus avoid the conflict of interest inherent in the possibility of earning commission income by causing the fund to turn over its portfolio. Terry Robards, Martin Remedy: Shake Up Big Board, The New York Times, August 8, 1971, section 3 at 1, 2.

78 The Study, supra note 10, paper 10 at 4.

79 Id. at 5.

80 The Policy Report, supra note 19, at 94.

81 The Study, supra note 10, paper 17, at 16, 17.
offered by Quirin and Waters that "no changes be made in the fee rate without prior approval of the fund shareholders." 82

THE REPORT OF THE CANADIAN COMMITTEE ON MUTUAL FUNDS AND INVESTMENT CONTRACTS: SALES CHARGES AND MANAGEMENT FEES

The Report appears most convincing where it deals with what may be termed the 'technical' standards for mutual funds, designed to protect the public from the misappropriation of money or securities, outright fraud and gross dishonesty. This would, for example, include such areas as: custodial and inspection requirements; 83 minimum capital requirements; 84 a formula for computation of net asset value per share; 85 and, confirmation of purchase. 86 We shall however focus our attention on those aspects relating to whether The Report, if implemented, would provide the framework whereby the investor will indeed receive a 'dollar's worth' for every dollar he invests, be treated fairly, and be properly apprised as to the nature of the particular commodity he is purchasing.

It is important to consider the fact that, while The Report was prepared by a Committee consisting of six members, 87 with the assistance of a staff, it was issued as a unanimous report. No minority report was included, nor is there any record of any ostensible individual dissent. This should lead us to the conjecture that a minority viewpoint lies hidden in the interstices of the lengthy document produced by the Committee and its staff. It will be methodologically useful to consider The Report in the light of a 'battleground' wherein two opposing forces contended. A meaningful analysis of The Report requires that we attempt to unravel the two separate layers of argument.

While we recognize the limitations of labelling as such, we shall, in some instances, in the form of a theoretical construct, distinguish between two separate reports, re-articulating each one in terms of its underlying philosophy: The hypothetical Report A will represent the viewpoint of the mutual fund industry and of those who would severely restrict the role of government regulation; Report B, the model of the residual minority report, is committed to an investor-protection thesis, and recognizes the need for a meaningful level of government regulation.

It is important to distinguish between these two separate and distinct approaches, because The Report ought to be considered as a political document, which attempts to appear to lend credence to a variety of approaches. The analysis here suggested will help separate appearance from reality, and will indicate when The Report is awarding victory to one side, while offering mere rhetoric as a concession to the other side.

82 Id. at 17.
83 The Report, supra note 1, at 228.
84 Id. at 192.
85 Id. at 458.
86 Id. at 556.
87 Id. preface, at ix.
Report A begins with the assumption that a mutual fund is a “vehicle whereby money is managed for a fee and may be withdrawn at any time by its owner.” Thus, the mutual fund, through the arm of the management company, provides a service for those who entrust their funds to it. The Report explains that it accepts this definition, as opposed to the one which views the mutual fund as an enterprise separate from the management company, and which consists of an investment portfolio operated for the benefit of its participants. The Report adopts the Report A view, which confers on the mutual fund shareholder the mere status of a depositor. A purchaser of shares in a mutual fund should expect to have little more voice in the affairs of the company than that which may be asserted by one who deposits his savings in a chartered bank. In purchasing a mutual fund share, he has delegated his power over his funds to a management company. In practical terms, a mutual fund does not function separately from its management company. In fact, the management company provides the protection of the fund assets, in place of the fund itself.

The U.S. Investment Company Act, 1940, requires that a mutual fund have a Board of Directors, of whom 40% are independent, and this is, primarily, with reference to the management company. Legislation under consideration by Congress, would make this provision more effective by changing the criterion of exclusion from “affiliated” to “interested” persons.

Report A decides against a statutory requirement for a Board of Directors at all, let alone an independent Board of Directors. Report A enumerates three reasons for ruling out such a requirement:

1. The American experience would indicate that it has not solved the three basic conflict of interest problems created when a management company deals on a non-arm’s length basis with a mutual fund, and these are:
   a. management compensation;
   b. allocation of brokerage commissions; and
   c. the setting of the sales load.

2. Because the management company controls the proxy machinery of the mutual fund company, the requirements designed to ensure an independent directorship, would have to be rigorous to an intolerable extent.

3. The very requirement of a “Board” itself, would impose an inconvenience on the Trust Companies which have organized mutual funds. “It would result in the isolation of these funds from the ordinary operations of trust companies through their treatment in different ways.” While a Board could be made mandatory, Report A is not satisfied that the results would be beneficial.

In sum, Report A questions whether “government should require that persons without a direct stake in the success of the operation be put in a

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88 Id. at 104. Cf. supra p. 620.
89 Id. at 150.
90 Id. at 162, 164. Cf. S.2224, 91st Congress 1st Session, May 27, 1969, at 2, 3, for definition of 'interested' person, and at 10, 11 for the amendment which would replace 'affiliated' with 'interested' persons.
position where they are expected to pass on the business judgment of the management company." While agreeing that an independent Board would be a good thing, Report A feels that it should be set up on a voluntary basis, and not by legislative fiat.

While Report A is victorious in gaining acceptance of its conclusion, Report B is granted the luxury of rhetoric. Report B says,

... there are certain obvious advantages to a mutual fund and its shareholders in a board of directors that includes at least some members who are independent of management. These members can assist management by subjecting its decisions to informed and impartial review, perhaps with comments based on backgrounds in other business activities. It can protect shareholders or unit-holders by ensuring that management properly performs the duties for which it is paid.

Aside from protecting the interests of the public shareholders, independent directors can serve as an effective sounding board for the evaluation of the management company's investment policies. An investment manager, whose vision may be blurred by involvement with the stock market on a daily basis, and influenced by the currents of emotionalism which engulf those close to the market, could benefit from the perspective and cool detachment of experienced businessmen serving on the Board of Directors. It may be true that in the case of industrial companies, many directors are appointed who simply know very little about the industry, and serve only because of their status and reputation. However, in the case of a mutual fund company, a capable, experienced businessman has usually had experience with the capital markets, and is capable of serving as a watchdog to protect the interests of the mutual fund shareholders.

Perhaps the assumption underlying The Report's reluctance to require a Board of Directors, is based on the above mentioned concept of the mutual fund investor as a depositor who deserves no representation through any directorial apparatus, simply by virtue of being a shareholder. Thus, a mutual fund shareholder is not to be likened to one who purchases shares of a stock that is, for example, listed on the Toronto Stock Exchange. The latter is a part owner of the business. However, the former is not an 'owner' in the same sense, and we would explain this by reference to the definition of the distinctive feature of the mutual fund, which is that the holder of a mutual fund share "is entitled to receive, on demand, an amount determined by

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91 The Report, supra note 1, at 164.
92 Id. at 165, 166.
93 Id. at 161.
94 A careful reading of G. Kaplan and C. Welles, The Money Managers (New York: Random House, 1969) will show that even some of the most talented mutual fund managers tend to be guided by one or two dogmatic principles which are effective in one type of stock market environment, but totally ineffective in another, with the result that they are not sufficiently flexible to adjust their investment policies to new developments. This may serve as a partial explanation as to why certain talented money managers did so well in the 1966-68 stock market, and then outperformed the stock market averages on the downside in the 1969-70 market.

Regarding outside directors, perhaps some provision could be made so that a director refrain from involving himself in an investment decision relating to a corporation on whose Board he serves; or, at least that the mutual fund Annual Report identify the fund directors who also serve on the Boards of portfolio corporations.
reference to the value of his proportionate interest in the mutual fund." It is true that the holder of a share in an industrial corporation, for example, may sell his share; however, there is no guarantee that he will receive, as consideration, the net asset value. He may receive more or less. We may therefore conclude that it is this distinctive feature which permits Report A to conclude that the 'ephemeral' shareholder of a mutual fund can perform his surveillance function, simply by redeeming, if he is dissatisfied with management. It would seem obvious that since this is the distinctive feature of the mutual fund, as highlighted by *The Report*, that this would be the basis of the justification for not requiring a Board of Directors, at all. If this is the case, we shall see that Report B refutes the rationale for not requiring a Board of Directors, which rationale is apparently adopted by Report A in arriving at its conclusion.

Report B contends that the availability of the right to redeem alone is inadequate to provide continuing scrutiny, for the following reasons:

1. Redemption is far less successful than continuing opposition as a shareholder.

2. To posit the right to redeem as a method of scrutiny would be to assume:
   a. That the shareholders possess the ability and knowledge to review management's activities; and
   b. That full disclosure of the relevant activities of management can be provided.

Neither of these assumptions can be made.

3. The theory assumes too much in two additional respects:
   a. That the shareholder will read what is sent to him. The weakness of this assumption will be obvious when it is realized that the mutual fund shareholder is, by nature, one who is unwilling or unable to participate in the management of his own investments.

   b. That the mutual fund shareholder would actually redeem. But, it must be remembered that he may lose money if he does so. If he is a contractual plan shareholder, he may lose the 50% of his total first year's purchase, that being the amount which represents commissions; and if a voluntary plan or lump-sum purchaser, 8.5%. This is aside from a possible decline in net asset value, which would make it an inopportune time to redeem.

4. Even if we are to assume that a certain number of shareholders will be sufficiently knowledgeable to redeem, it is no solution for the wealthy and sophisticated to drop out of the mutual fund, leaving those most in need of protection, within the fold of the mutual fund!

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96 Cf. *infra* p. 627 for a specific suggestion as to a source of directorial talent.
97 *The Report, supra* note 1, at 113.
98 We shall see below that this fundamental assumption made by Report B is not recognized at all by Report A when it would attempt to rely on competition as a means of governing the level of sales charges and management fees.
99 *The Report, supra* note 1, at 158-60.
Thus, Report B undermines the basic assumption upon which Report A rests its conclusion not to require an independent Board of Directors, or even a Board of Directors as such.

The contention that the American legislative solution, requiring independent directors, has not proven especially successful, does not justify the position taken by Report A. Developing a statutory solution to a problem is frequently an evolutionary process, rather than an absolutely imminent solution. In this case, we may benefit from the experience in the U.S., and take note of the proposed legislation designed to close the loopholes in the requirement of independent directors.9

The assertion that it would be 'inconvenient' for the Trust Companies to set up a separate Board of Directors for the mutual funds they organize, should not be doubted. It is indeed far more convenient for the Trust Company to mingle all of its investments, such as mutual funds, trust accounts, individual accounts, Registered Retirement Savings Plans, and treat them all as one, in many respects. However, this is not entirely fair to the mutual fund investor, who pays .75% as a management fee for specialized professional attention to the fund. One cannot criticize consultation between various divisions of one Trust Company, but treating all of the Trust Company's investable funds as one entity, can work unfairness on the fund investor. For example, if the fund's 10,000 shares of Bell Telephone will be purchased as part of the total of 50,000 shares for all of the Trust Company's units, the fund may, in the end result, pay more for the 10,000 shares than if it purchased the shares on its own separate account. The Trust Companies ought to be required to maintain the separate identity of their mutual funds, each fund governed by a separate Board of Directors to outline a consistent investment policy and oversee its operation, in order that it be managed as an individual unit or division, instead of as a 'stepchild'. It would also simplify the regulatory problem, so that the mutual fund unit could be kept separate from the Trust Company, enabling it to be regulated by the Securities Commission. These are only some of the 'benefits' which would flow from requiring the Trust Company mutual fund to maintain a Board of Directors.

Report A resists the adoption of a 40% independent Board of Directors requirement, similar to what is in force in the U.S., because of the fact that in Canada a small number of directors serve a number of companies that are affiliated with one another. Thus, many potential directors would be excluded from serving on mutual fund boards, because they would fall under the category of 'affiliated' or 'interested' persons.10 For example, if the Canada Permanent Trust Company organizes a mutual fund, and then appoints the Vice-President of the Bank of Nova Scotia as an independent director, he may be excluded if it is found that the Bank of Nova Scotia owns a large percentage of Canada Permanent stock.

9 Mutual Fund Legislation of 1967 Part 2, Hearings Before The Committee On Banking And Currency, United States Senate, Ninetieth Congress, Statement of Professor Ernest Folk III, beginning at 1001. Cf. at 1004-06 for an excellent discussion on the improvements that will result from the 'interested' persons definition in the proposed legislation.

10 Cf. sources referred to in notes 90 and 99, for U.S. solution for insuring the independence of the specified percentage of the Board of Directors, i.e., 40%.
It could be argued that this is probably one of the most convincing reasons for, in fact, implementing the independent director requirement for mutual funds. It might, as a favorable by-product, afford a partial solution to the problem of 'in-breeding' in Canadian corporate management. It would be meritorious, for example, if mutual funds would be constrained to seek out directorial talent from among the faculties of our universities and colleges. It may be suggested that there are many talented professors who are scholars in various areas of finance and commerce, who could make a very significant contribution to the management of mutual funds, and to the protection of the shareholders' interests.

The concept of the appointment of directors who are to devote themselves to protecting interests outside the narrow purview of the managerial group, is gaining adherence in the field of corporate and securities law. The Toronto Stock Exchange Act, 1968-69, provides for the election of two public directors to the TSE Board of Directors, and the two nominees must be approved by the Lieutenant Governor (the Cabinet). While this is not analogous to the case of the mutual fund board of directors, it is asserted that a board of an institution with a quasi-public utility or public interest character, must include members who shall owe a duty to the generally 'unrepresented' public, and not to be beholden to the 'control' group.

As though to compensate for its triumph with regard to the Board of Directors, Report A allows Report B to adopt the American provision which requires that the management contract be placed before the shareholders for approval every two years. The approval shall be by majority vote. Also, the shareholders should be given a right to approve, where certain specified changes are made in the policy of the mutual fund; and these are specifically enumerated. They are, in the case of “material amendments to the management or distribution contract, or to the statement of investment objectives and practices; transfer of management contract;” and in two instances, where required by the securities administrator. Report A approves of this, because it is consistent with its conception of a mutual fund as a method whereby a management company sells investment advice. The investors entrust their money to the management company on a specified basis, and when that basis is changed they ought to have a voice in such change.

Report B makes this right of approval on the part of shareholders, meaningful in a certain sense, by giving the securities administrator the power to require a clear statement of investment objectives, to the extent, at least, that such precision is possible.

However, it is in the apparatus designed to make the right of dismissal effective, that Report A asserts itself. It speaks of “dismissal of management in a very serious case” and the dismissal “of an inefficient management company.” We note that the approval of management is by a majority vote.

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101 S. 6(1)(b) and s. 7(2). Text of the Act appears in the preface to the TSE By-Laws, December, 1969. These provisions leave something to be desired, but the Act asserts the principle, at least in a general way.
102 The Report, supra note 1, at 168-70.
103 Id. at 452-54.
104 Id. at 169.
The crucial part of the proposal, is that which provides machinery for replacing the management company, and provision is made for a dissatisfied shareholder to approach a nominee management company which will be prepared to assume the responsibility of managing the fund, as long as the nominee places $50,000 in trust to satisfy the escrow requirement, should the shares held in escrow by the incumbent management be released. The incumbent management would be obligated either to provide the nominee with a list of shareholders, or “to send material on behalf of the nominee management and distribution company to all those entitled to vote at the meeting, on payment of reasonable costs of mailing.” However, incumbent management “would be deemed to be confirmed unless voted against by the holders of more than 66\(\frac{2}{3}\)% of the shares or units present in person or represented by proxy.” This means that the incumbent management could maintain itself in office, by mustering only one vote more than 33\(\frac{1}{3}\)% of the votes. Report A justifies the requirement of a 2/3 majority for replacement, on the ground that it would avoid the possibility of the abuse of these procedures. Report B, however, manages to add, “this (66\%) percentage requirement should be kept under continuing review and increased to a requirement for approval by majority vote if the relevant provisions prove ineffective to accomplish their objective.” But, no criteria are suggested for an evaluative assessment. In other words, how are we to know whether it is or is not achieving its objective?

There is reason to believe that Report B is justified in its concern as to the effectiveness of this proposal which is designed to allow for the replacement of the management company. It would indeed be difficult for dissident shareholders to gather a 66\(\frac{2}{3}\)% vote against management, unless management was performing its functions in a grossly inefficient manner. And, even if this were the case, incumbent management possesses all the ‘evidence’, and the challengers would experience some degree of difficulty in obtaining such information that would enable it to offer a convincing argument to the shareholders.

It is important to note that The Report mentions nothing about replacing incumbent management with a nominee management company which would provide the same service for a lower fee. Instead, it refers to inefficiency of the management organization. Perhaps The Report well realizes that the dissident shareholder will find it next to impossible to persuade any management

\begin{footnotes}
\item[105] Id. at 394.
\item[106] Id. Cf. Interim Report of The Select Committee On Company Law, 1967, esp. at 69-82, for proposals designed to strengthen the position of minority shareholders. See, The Business Corporations Act, 1970, S.O. 1970, c. 25, ss. 99, 101. Thus, the current tendencies in the Company Law Reform Movement, would suggest the application of the principles of shareholders rights, let alone minority shareholder rights, to mutual fund companies.
\item[107] The Report, supra note 1, at 394.
\item[108] Id. at 397.
\item[109] Cf. id. at 153-58, for an account of what happened when an independent board of directors of Commonwealth International Mutual Fund lost a proxy battle to oust the management company, Canadian Channing. The Report, at 157, says that the Channing victory “as a practical matter was probably due more to the efficiency of its proxy solicitation through the direct sales force and to the apparent tendency of dissatisfied shareholders to redeem rather than cast negative votes.”
\end{footnotes}
organization to stand for election to replace incumbent management on the basis of lowering the management fee. It would realize that it could well be the victim of a cost-cutting challenger in a subsequent contest, and in addition, would not want the stigma of fostering a 'price-war'. The same reasons which make it difficult to persuade a Doctor to testify against a colleague in a medical malpractice suit, would obtain in such a case. Furthermore, a management organization would tend to be reluctant to put up the $50,000, and to bear the costs of the mailings to shareholders together with the expense of preparing 'campaign materials' in order to make a case for itself, in view of the risk of losing the contest. The odds in favour of the nominee management would be very low, because of the fact that it must gain the adherence of two-thirds of the shareholders, while incumbent management can win with a little over one-third, and for the reason that fund shareholders, taken as a whole, tend to be apathetic and favour the status-quo, regardless of whether or not it is in their interest.

For the reasons stated above, with regard to the contention of Report B,110 to the effect that mutual fund shareholders are not activists, by definition, because they have chosen not to manage their individual portfolios and that they do not tend to read mutual fund materials mailed to them, and fail to understand the involved matters relating to mutual fund management, this proposal is relatively meaningless. An alert and active management can easily defeat the shareholders, many of whom are apathetic. Thus, this proposal is a poor substitute for a Board of Directors, with independent representation, which can evaluate the management company, and challenge it wherever necessary.

Thus, we see that Report A rejects any mechanism to control fees charged by management companies, and condones the non-arm's length negotiations with the mutual fund, on the basis of which the management fee is set. It also rejects the requirement to fix a reasonable management fee, as well as a maximum sales charge.111

Report A pleads ignorance as to any criteria for fixing a sales charge. In reality, it appears that this Report does not wish to lower sales charges at all. The Report says that "the costs involved in the sales activity increase with the rewards to be earned."112 In other words, the higher the sales commission, the more effort or money that will be expended to earn the sales dollar. We would note that this, however, may not necessarily be an expenditure designed to benefit the investor. But, Report A employs a very definite interpretation of the relationship between the sales effort and the compensation. It assumes that the sales effort which will increase with a generous sales charge, will redound to the investor's benefit. Again, The Report—"If sales charges are high, a salesman may be able to spend a great deal of time with one customer; if they are low, he may not even be prepared to meet the customer."113

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110 Cf. supra, p. 626.
111 The Report, supra note 1, at 322, 323.
112 Id.
113 Id.
There is reason to believe that this is not a necessary equation. It can be said that the salesman will tend to spend the least amount of time with the customer that he can, while selling the maximum volume of fund shares on the 'plan' which will bring him the highest commissions.

One may assert that the higher the sales charges, the less time the salesman will want to spend with an individual prospect, because he will be impelled to move on to reap the generous rewards to be gained by contacting another potential customer. In place of the Report A analysis, that high commissions motivate the salesman to spend more time with a customer, and low commissions the reverse, a more useful result can be achieved by distinguishing between the competent and the incompetent salesman. The competent conscientious salesman will realize, regardless of the particular commission scale, that if he is to build a long-term stable clientele, he has a responsibility to educate the customer and to service his accounts properly. The incompetent salesman, who fails to appreciate his duty to inform and educate his customer, will fail to do so even in the face of a higher commission level. However, the lower sales charge can result in a benefit to the customer, in that the incompetent marginal salesman will be eliminated.

In this connection, it is interesting to refer to the comments made by a panel of top officials of mutual fund management and distribution companies, as reported in an American trade journal. The panel members are particularly concerned with the lack of 'servicing' of clients accounts on the part of some mutual fund salesmen. Herman Friedman, Vice-President of Tsai Management Company says that the Investors Diversified Service-type of organization, has a lesser redemption problem than other funds, because, "These people are drilled into servicing their accounts, whereas a warehouse-type salesman, or one who isn't captive, usually won't go back to his client after his initial contact, for servicing." Thus, proving that service appears to be a function of the sales organization's standards of training rather than of commission scales!

Donald W. Spiro, President of Oppenheimer Management Corporation, stated that despite currently high commission rates, a special bonus must be offered to salesmen, in order to encourage them to do what they ought to be doing anyway. This is after they have been presumably motivated by the generous commissions they earn. Spiro says,

We've developed a program through the years of what we call a servicing bonus, where dealers receive a special bonus at the end of the year for properly servicing the account. I think too much attention today is paid to what type of sales you can offer, how large the volume is, etc., instead of coming back to the service.

Spiro also believes that the salesman today is not doing an adequate job of informing the client, and he attributes this to lack of training, rather than to any deficiency in commission schedules.

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¹¹² Id. at 31.
¹¹³ Id. at 33.
prospect, the prospect understands what he bought. The average individual now has no idea of what he bought.117

These industry leaders study the figures of redemptions, and the volume of return business from existing shareholders, and are disappointed with what they find. They are concerned with a high rate of 'redemptions', which indicates 'poor' selling, that is, high-pressure sales to those who really cannot afford to hold an investment in a mutual fund. They attribute this phenomenon to the low standard of salesmen training, and to the lack of proper 'servicing' of a client. The salesman is satisfied when the client purchases the fund shares, whether or not he understands the commodity he is buying. Thus, unlike Report A, these top officials of the mutual fund industry, do not relate this failing on the part of the fund salesmen, to the structure of commissions. They are well aware that they could not do so because commissions are currently very high, and the industry leaders are equally well aware of the low calibre of the mutual fund salesman, which is the focus of their complaints.

While Report A contends that management fees can not be set by regulatory authorities, Report B expresses a degree of skepticism as to the way they are currently being set. Report B refers to the CMFA brief, which asserts a substantial minimum requirement in fees in order to provide investment advisory services, and says that it fails to accept this analysis. Firstly, the CMFA fails to make allowance for the reliance on investment advisory services provided by stock brokerage firms in return for the substantial commission business resulting from the securities trading on the part of mutual funds. Secondly, an indicator that management fees may be excessive is the fact that "we have found cases in which a management company charges a higher rate for the management of a mutual fund portfolio than for the management on a contractual basis of a portfolio of comparable size on behalf of a large institutional investor."118 This finding, in the case of the U.S. management companies, has been painstakingly and carefully documented by the studies prepared by the SEC.119

In this connection it would be appropriate to illustrate the extent to which the mutual fund industry spokesmen in the U.S. have perverted logic to avoid the implications of this finding. The SEC has charged that, in order to show that their profits on providing investment advisory services are modest, the management companies have presented their profits "as a percent of the capital of the funds" instead of as a percent of the advisers' gross revenues or invested capital. The SEC submission to the Senate Committee considering legislative revision of the Investment Company Act, 1940, calls this an absurd basis for comparison. This peculiar method of calculating profit margins would be somewhat comparable to a law firm calculating its profit margin by comparing its earnings with the aggregate of the capital belonging to the firm's clients. To cite from the SEC statement,

It is the investment advisers, not the funds, which receive these fees and make these profits and, in many instances, the pre-tax profit ratios of the investment

117 Id. at 35.
118 The Report, supra note 1, at 323.
advisers are very handsome, ranging up to 65 percent or more of their advisory fee revenues and a far greater percentage of the modest capital required by investment advisers.\textsuperscript{120}

We should also note, in this context, the above mentioned reservation as to the portion of the management fee which is employed to benefit the mutual fund shareowner by providing adequate securities analysis resources, as opposed to the portion of the fee allocated to profits.\textsuperscript{121}

Despite the imperative to formulate a workable system to regulate management fees, as well as sales charges, Report A comes to the fore, and rejects any suggestion associated with regulation and compulsion. In the case of sales charges, as discussed above, it is difficult to find a level which would enable distribution companies to perform their functions. In the case of management fees, it is difficult to analyze expense and profit levels of management companies, “because of the problems in a separation of revenue and expenses attributable to other activities of management and distribution companies.”\textsuperscript{122}

Such a conclusion, would impel one to question whether the management companies were charging their ‘captive’ mutual funds a fair fee for advisory and other services, on the basis of a true assessment of costs plus a reasonable profit margin. This assertion, on the part of Report A, represents a cogent argument in favour of instituting a more systematic and precise method for determining management fees. This view, as to the indefiniteness of management company expenses, would tend to confirm the assumption that, frequently, mutual fund management fees serve to ‘subsidize’ other investment services provided by the management company for a lower fee. The consequence is that the mutual fund purchaser fails to benefit from the economies stemming from the pooling of funds and the resultant economies of scale, to the extent that he should.

In sum, Report A concludes that there should not be any statutory limit on sales charges or management fees, and that securities administrators should not continue to be “the arbiters of the entrepreneurial reward to be derived from the operation of mutual funds.”\textsuperscript{123} In fact, it is not possible for securities administrators to set maximum levels for these charges, because there is no way of knowing what is a proper rate. “They may presently be ‘too high’ or ‘too low’.”\textsuperscript{124} This, of course, is in contradistinction to Report B, which has indicated that there is reason to believe that management fees may be unfairly high, because of the fact that many investment research services, for which the advisory fee purportedly pays, are being provided by stock brokers’ research, paid for by brokerage commission fees; and because clients other than mutual funds are paying less for the same investment advisory services provided by the same management company.

\textsuperscript{120} Supra note 99, Senate Committee Print, at 1196.
\textsuperscript{121} Cf. supra pp. 621, 622.
\textsuperscript{122} The Report, supra note 1, at 322.
\textsuperscript{123} Id. at 324.
\textsuperscript{124} Id. at 325.
REGULATION BY COMPETITION

Report A asserts that “the only effective way to control the level of sales charges and management fees would be through the operation of competition in these areas at the consumer level.”

We shall examine the means by which Report A would achieve the level of competition necessary to effectively control sales charges and management fees. A very critical part of the task is to convert the large majority of mutual fund purchasers to whom the fund is an ‘unsought good’ to those who view the mutual fund as a ‘shopping good’. The shoppers are the ones who take the initiative and compare the funds as to sales charges and management fees prior to making a selection.

We need only cite from a consumer survey that is discussed in Report B, to show that the vision of a large number of mutual fund investors, sitting down with pencil, paper and slide rule to compare the differences between the funds is entirely illusory! The survey concluded that in a majority of cases, the salesman took the initiative to arrange the interview, and in approximately half of the instances, the salesman made the sale on the first visit. Of those who replied that the initial contact was made on the initiative of the salesman, 89% of contractual planholders and 85% of lump sum purchasers contacted no other organization prior to the purchase. Since salesmen comment on comparative performance figures, but not on comparative sales charges or management fees, Report B concludes that an imposing majority of persons purchase mutual funds without bothering to make a comparison as to costs — that is, if they are even aware that they are paying such fees altogether! These facts provide little reason for optimism that mutual fund consumers can be easily instilled with the requisite degree of sophistication which will provide fertile ground wherein effective competition may flourish.

We tend to become more skeptical of this proposal when we recall the suggestion made in Report B that the mutual fund purchaser, by his very nature, is one who is not given to careful analysis and contemplation of the alternatives, because, if he were such a person, he would choose to manage his own portfolio rather than delegate the responsibility to a management company.

Let us examine The Report’s recommendations which are designed to overcome the formidable impediment to effective functioning of competition represented by consumer apathy. To open the avenue to competition, The Report unequivocally recommends abolition of retail price maintenance, which is the current system whereby management and distribution companies set the level of sales charges as a minimum, and prohibit the sales organizations and salesmen from breaching that minimum level.

Although abolition by statute of Retail Sales Price Maintenance may result in discrimination between mutual fund purchasers in that some will pay

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125 Id. at 324.
126 Id. at 51.
127 Id. at 51, 52.
128 Id. at 159; Cf. supra p. 626. Cf. also, supra pp. 603, 604, 605, re Quirin and Waters and their assumptions about competition in the industry.
129 The Report, supra note 1, at 346.
higher sales charges than others, the proposal has merit, because; "After all, the right to bargain as to price is available with many items and the law does not ordinarily assume that unfairness is present if one person is able to obtain a better price than another." Of course, what is more critical, in real terms, in place of the right to bargain, is the willingness and ability to bargain effectively! Does pitting the small investor against the large mutual fund organizations, make for a contest between equal bargaining entities? In other words, compulsory repeal of the de facto retail sales price maintenance may not result in an actual reduction of sales charges, leaving us with a distinction without a difference, or an "improvement" without a benefit to the consumer.

The Report, in all candor, admits to this possibility. It asserts that it makes no assumption that "the introduction of competition with respect to sales charges would result in a reduction of sales charge levels." It concedes that "it could also be argued that the removal of the existing administrative constraints over sales charges would permit them to increase despite the prohibition of retail sales price maintenance." This possibility attains credibility when we remember that the direct sales forces of the mutual fund management and distribution companies represent the major channel of distribution of mutual fund shares. The large distribution companies with the captive sales forces, being the major force in the Canadian mutual fund industry, would be able to control the sales charge regardless of the abolition of retail price maintenance. The Report considers this possibility and agrees that this will be the case in the initial stages, but that eventually, independent sales forces, which are presently a small factor in the industry, and brokers, will reduce sales charges. This will cause purchasers to put pressure on the distribution companies which sell directly, to lower their sales charges.

This, however, necessitates the acceptance of a number of propositions which are purely hypothetical, for example, that the independent salesmen and brokers will indeed wish to lower prices to a significant extent, and that the mutual fund buying public will be sophisticated enough to search out, compare, and purchase the fund which calls for the lowest sales charges.

It would be appropriate, at this juncture, to suggest that the legislative proposals propounded by the U.S. S.E.C. to retain section 22(d) of the Investment Company Act, 1940, the statutory retail sales price maintenance provision, and to place a general ceiling of 5% on sales charges to mutual fund purchasers, would solve many of the problems inherent in the proposals of Report A.

Manuel Cohen, the former Chairman of the S.E.C., believes that abolition of retail price maintenance may not make very much difference in practical terms, and that placing the ceiling of 5% on sales charges will constitute a far more effective remedy for the consumer who needs the protection. He

130 Id. at 339.
131 Id. at 343.
132 Id. at 33.
133 Id. at 35.
134 Id. at 341, 342.
135 Supra, note 33, House Committee Print, at 30, 59, 60.
is not entirely certain of the results of abolition of retail sales price maintenance, but he is certain that the 5% ceiling will result in an immediate and justifiable across-the-board price-reduction for the mutual fund buyer. In evaluating repeal of section 22(d) of the Investment Company Act, 1940, Mr. Cohen also takes note of the major role played by the large mutual fund complexes which sell through their own sales organizations. As long as there is only one seller of the shares of a particular fund there can be no price competition. He doubts that competition on the part of mutual fund shares offered by independent dealers will suffice to reduce the price of shares offered by those who sell through "captive sales organizations".

If the captives were able to keep their sales loads at levels higher than those prevailing in the competitive sector of the industry, they might be able to attract salesmen away from the independent dealers. Moreover, principal underwriters of dealer-distributed funds might conclude that they could escape from competition and elicit more intensive sales efforts by switching to the captive method of distribution, gradually eliminating the independent dealer who offers a variety of funds.136

Mr. Cohen then proceeds to voice the arguments in favour of repeal of s. 22(d). He deals with the argument that repeal of s. 22(d) would foster competition, thus providing the knowledgeable investor with the opportunity to obtain the product for a lower price. However, he says that an important theme of securities regulation has been concern with the welfare of the "unsophisticated investor, who is often the one most likely but least able to bear the burden of high charges in a competitive market. If it is desirable for millions of unsophisticated investors of modest means to invest in securities through the medium of mutual funds, it is also desirable that they should not subsequently have cause to believe that they were unfairly dealt with."137

The Report, however, believes that it is possible to transform the masses of unsophisticated purchasers into knowledgeable investors, and it proposes three methods for so doing.

First, through the medium of sales literature offered by the mutual fund salesman. The Report will set standards for this literature so that it will conform to the principles of fair disclosure.138 However, the oral presentation of the salesman is more important than the piece of literature he leaves with the prospect, which, in many instances, very likely remains unread. Sometimes, the salesman will use the literature as a prop for his sales talk, and merely refer to those parts of it which support his contentions.

Secondly, dissemination of information by government, with the cost paid for by the government.139 This is of doubtful value, especially when we recall the efforts of government to publicize programs which it alone administers. We should also note that the disclosure the government may make is circumscribed by the fact that it has no right to exhibit favoritism for any

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136 Id. at 60.
137 Id. Cf. also supra, note 99, Senate Committee Print, at 1011, 1012, Statement of Professor Ernest Folk III for an excellent analysis of the problems involved in repealing retail price maintenance.
138 The Report, supra note 1, at 327.
139 Id.
particular fund, regardless of how advantageous it might be for the consumer to consider its merits.

The third technique designed to enhance the investor's knowledge so that he will be equipped to demand and obtain the mutual fund which offers him the lowest sales charges and management fees, is the presentation of adequate and complete information by the communications media such as the financial press, television and radio. The financial papers would be encouraged to publish comprehensive comparative data about the various funds, to include material reflecting on the "quality of investment management, sales charges, management fees and other relevant factors in order to enable purchasers to base their selections on adequate comparisons." The Report insists, quite properly, that the media report the data on a basis by which comparison can be properly made. Instead of reporting the management fee alone, the newspaper ought to refer to the expense ratio, because management companies can hide the true cost of their managerial activities, by allocating part of the expense to the mutual fund.

The Report proposes that the regulations of the Canadian Radio-Television Commission be relaxed so as to allow mutual fund advertisements on television. It should be noted that television advertising simply is not constructed so as to allow the comprehensive detailed presentation of figures with the degree of comparability which would be required to paint a complete picture for the unsophisticated investor. Among the many problems raised by such a proposal, is the great potential for misrepresentation. The very nature of the brief television commercial, lends itself to a misrepresentation by omission, when the subject matter is a complex financial instrument, such as a mutual fund.

The efficacy of the proposal regarding financial newspapers is to be doubted. Aside from the fact that the circulation of the two major Canadian financial newspapers is limited, those who do not subscribe to them are the very ones who ought to be reached. Mr. Manuel Cohen, approached the problem with a great deal of sensitivity towards those who were not sophisticated businessmen, — as he questioned whether competition would

substantially reduce the sales load for the widow who has never heard of the Wall Street Journal, who is solicited in her home by a mutual fund salesman to invest the life insurance proceeds that she has just received, who has no basis for bargaining with the salesman on any semblance of an equal footing, and who is unaware of what comparison shopping could do for her in this field.

Aside from the above problem, it is doubtful that The Report realistically considered the volume of statistical information that the newspaper would have to carry to effectively apprise the people of the relative advantages or disadvantages of the various funds. In this connection, it would be helpful to consider the type of data reported in an American monthly publication, Fundscope which presents in comparative form all the type of information The Report would consider indispensable and relevant to the individual who would like to be a careful and sophisticated mutual fund investor. Every

140 Id. at 333.
141 Id. at 331.
142 Supra, note 33, House Committee Print, at 60.
month *Fundscope* publishes various articles designed to help the investor evaluate funds, and each month it includes an extensive comparative statistical section covering most of the American mutual funds on a different basis, that is from a different vantage point. For example, one month it might cover ‘five year performance records’, another time, the hypothetical historical operation of a dollar-cost averaging program, or the actual operation of a withdrawal plan over a period of time, covering all of the mutual funds. All of these are instructive and relevant, because they cover different aspects of mutual funds, their costs and performance over different periods, and on the basis of different investment programs and plans. Among the important figures or categories included in the *Fundscope* Mutual Fund Guide are, portfolio turnover rate; management fee; expenses: as a percentage of assets, and as a percentage of income; distribution of fund assets; total issues held; assets, etc. One listing of funds in the April, 1969 issue included seventeen categories of information, and referred the reader to another section or listing which covered twelve additional categories of facts which the prospective investor would want to know before choosing to invest in a particular fund.

Once a year, in April, *Fundscope* publishes an expanded “Mutual Fund Guide” which contains a most comprehensive listing of information about mutual funds. It is interesting that each monthly publication is required by the S.E.C. to include, on the cover, the following legend: “The Statistics in *Fundscope* conform with SEC's Statement of Policy and are cleared for use provided accompanied by *Fundscope*'s ‘Mutual Fund Guide’, and the appropriate Fund Prospectus.” This means that for selling purposes, even when the salesman provides the Fund prospectus, it is not sufficient to present the quite extensive statistical material in the *Fundscope* monthly edition, without presenting for the prospective purchasers’ perusal, the most comprehensive statement of comparative statistical material, the “Mutual Fund Guide”. This is to suggest that if a specialized monthly publication solely devoted to mutual funds, is viewed as incomplete in terms of comparability without a large (307 pages for the 1969 edition) comprehensive Mutual Fund Guide, how can a financial paper be expected to present adequate material to allow for fair comparison?

It is true that there are many more funds in the United States than in Canada. However, we should note that there are 136 mutual funds qualified for sale in Canada.\(^\text{143}\) In any coverage of mutual funds, designed to enhance competition, the American funds that are qualified for sale in Canada should also be included. It should be noted that under *The Report's* recommendations, American Mutual Funds will continue to be sold in Canada, provided that the American authorities relax their regulations so as to permit Canadian Mutual Funds reciprocal rights.\(^\text{144}\)

It is apparent that the task of presenting factual material about the mutual funds on a comprehensive basis to educate an unsophisticated investor, is not one which can be accomplished by materials that may be included on

\(^{143}\) *The Report*, supra note 1, at 727, for number of funds qualified for sale in Canada. However, a count of the mutual funds listed in the FP Survey of Investment Funds, 1969, including only the open-end funds, indicates a figure closer to 200.

\(^{144}\) *Id.* at 646.
one page of a newspaper on an occasional basis. There is reasonable doubt that such information can be conveyed in any meaningful manner in the span of a brief television commercial!

We have discussed competition from the point of view of the investor who would have to become knowledgeable to the extent to which he could exploit the competition that the various mutual funds would be engaged in by cutting prices and management fees. In examining this latter half of the equation suggested by Report A, we suggest that it too suffers from decided weaknesses, particularly in the absence of recommendations to legislate against mergers, collusion and price-fixing as between the mutual funds, or the sales organizations. The Report recognizes the fact that the Combines Investigation Act does not cover mutual fund shares, because it refers to articles or commodities.\footnote{Id. at 335.} The Interim Report on Competition Policy\footnote{Economic Council of Canada, July 1969. The Interim Report on Competition Policy [hereinafter The Interim Report].} indicates that the Canadian anti-combines legislation is to forbid agreements "which would prevent or lessen competition in relation to an article or to the price of insurance upon persons or property."\footnote{Id. at 51. Cf. also, at 141 for discussion of the history of the statute with regard to the fact that the scope of the statute is restricted to activities relating to articles and the price of insurance.} The Interim Report explains that the Combines Investigation Act does not apply to most service industries, and the financial institutions would be included in the category not covered by the Act.\footnote{Id. at 65, 148.} The Interim Report proposes a strengthening of the anti-combines legislation, with the establishment of a Competitive Practices Tribunal, with civil powers, to embrace all economic activities, including the 'service-producing' industries. It stresses that services ought to be included within the purview of the legislation, where other types of "social control" did not apply.\footnote{Id. at 148.} While not referring directly to the mutual fund industry, The Interim Report says "that the application of competition policy is as relevant to the provision of financial services as it is to other fields."\footnote{Id. at 153.} However, in a discussion of the minimum commission rates of the stock exchanges, it suggests that

If the public is in fact best served by permitting these practices to continue, they should be protected by appropriate regulatory legislation. The regulations should, however, spell out explicitly what sorts of agreements are to be allowed and under what circumstances.\footnote{Id. at 146. The Competition Act, Bill C-256, 1971, s. 91 provides that securities underwriters be exempt from the agreement and arrangement prohibitions in the Act: S. 91(1). Sections 16 and 18 do not apply in respect of an agreement or arrangement between or among persons ordinarily engaged in the business of dealing in securities, that relates only to the underwriting or to the primary distribution of an issue of bonds, debentures, shares or other like securities. See also s. 91(2).} The Interim Report, would suggest that where competition is either not feasible or possible, the alternative must be that the activity be governed by
regulation that is designed to protect the public. However, if the position of Report A were to be accepted, there would be neither effective regulation of prices, nor true competition. To achieve the latter, The Report would have to relate the mutual fund industry to the anti-combines legislation, and recommend that it be brought under the authority of a body such as the Competitive Practices Tribunal. It should be emphasized that the Report A recommendation is merely to prohibit “agreement between a distribution company and sales outlets through which it affects sales, if the agreement prevents the sales outlet from reducing its compensation on the sale of shares or units in order to produce a commensurate benefit to the purchaser.”

This would apparently not prohibit agreements between distribution companies, or between sales organizations; nor would it prohibit mergers. It would not prohibit active nor tacit collusion between mutual fund industry leaders to maintain prices at certain levels, or to follow a familiar pattern of commission rate increases led by one or two of the major mutual fund organizations.

It is interesting to refer to The Porter Report, which is concerned with insuring the development of competition in the banking industry. It indicates a realization of the importance of seeing to it that “the habit of formal or informal agreement ... should be broken.” The Porter Report makes some very concrete proposals designed to prevent collusion in respect of banking, and we would note that we find no similar recommendations in The Report, that would be designed to lend credence and effectiveness to a competition policy in respect of Mutual Funds. The Porter Report recommends “that all agreements among banking institutions affecting the terms and conditions of borrowing or lending be prohibited unless specifically approved by the Minister of Finance.” And “agreements relating to banking procedures and charges for routine services” would have to be filed with the Inspector General, and he would bring to the Minister’s attention instances where they are against the public interest. “The legislation should thus grant the Minister power to hold inquiries, to issue stop orders and to take such other action as may be necessary to prevent undesirable agreements.” Thus, at the very least, a serious attempt to create a framework of competition through legislative prescription and administrative action. The ultimate effect of the Report A ‘competition’ proposal is that the mutual funds will be permitted to operate in an environment where there is no effective competition, nor a government regulatory apparatus to control sales charges and management fees.

It should be remembered that Report A’s projection of an era of competition between funds which will be striving to attract the attention of the well informed investor exposes The Report to a degree of internal inconsistency with reference to its rationale for a high level of sales charges. Report A stresses the importance of sales charges, as enabling the salesman to devote ample time to a customer and indeed the sales force is said to

102 The Report, supra note 1, at 346, 347.
103 The Competition Act, Bill C-256, 1971, ss. 32-36 for provisions regarding mergers and interlocking directorates.
104 Supra, note 5, at 370.
105 The Report, supra note 1, at 322.
contribute to the welfare of individual investors by expanding the public interest in equities. 156

In terms of Report A’s framework, once various measures have been taken to educate the public in the technique of choosing mutual funds, and the ranks of the ill-informed investors reduced to a small minority, the need for and the role of the salesman will become severely restricted. The justifications of the salesman’s role and his high cost to the purchaser, will no longer obtain. The approach of Report B suggests an awareness of this possible result when it discusses the view that high sales charges justify the time and effort required to persuade an obstinate person who lacks financial knowledge, that a mutual fund investment would be appropriate for him. Report B questions the need for high sales charges which may be rationalized only by such marginal sales activity. But, instead of arriving at the conclusions which follow from its premises, it veers back into the path of the ‘competition’ argument formulated by Report A. 157

It cannot be over-emphasized that the functioning of an effective competition, with a well-informed public, assumes a sales force capable of raising the level of public discourse about mutual funds. In this regard, The Report lacks internal consistency too, because, as we shall see below, The Report takes no significant initiative in raising the selection and training standards of salesman, and in fact, makes recommendations which would tend to lower the standard of salesmanship.

It would be helpful at this point to refer to the views of a prominent American expert in economics and the capital markets, as to the nature of competition in the mutual fund field.

Professor Edward Herman, of the Wharton School of Finance and Commerce, one of the authors of The Wharton Study of Mutual Funds, in his statement delivered before the U.S. Senate Committee studying the S.E.C. proposals for amending the Investment Company Act, 1940, focuses especially on the competition aspect. He finds that competition has not worked in the determination of management fees and sales charges, and to the extent that it has worked, it has been “perverse” competition. He suggests that competition would not work effectively even with a “drastic structural reorganization of the industry.” 158 He regards the S.E.C. legislative proposals, which can be briefly summarized as setting a 5% maximum on sales charges, and setting up a standard of “reasonableness” for management fees to be tested judicially, as being a conservative compromise between doing nothing and effecting radical changes in the industry structure. We should take note of the fact that when Professor Herman finds a vacuum of competition, he is speaking in the context of an American mutual fund industry, which includes a multitude of different types of funds, a mature ‘no-load’ industry, and well-developed publicity through the medium of sophisticated journals and publications. In other words, many of the conditions that Report A suggests for the implementation of competition in the Canadian industry,

156 Id. at 511.
157 Id. at 327.
158 Supra, note 99, Senate Committee Print, at 726.
already exist in the United States, with the significant exception of the existence of Retail Price Maintenance by statutory sanction.\footnote{Investment Company Act, 1940, s. 22(d).}

Professor Herman suggests two basic reasons for the absence of competition in the mutual fund industry. Firstly, it may be attributed to the system of organization of the mutual fund, with an “external manager and the absence of arm’s length bargaining.” The second reason is based on an analysis of the buyer’s side of the market, in the sense that the market is uniformed; and is very much at the mercy of the salesman. This is borne out by the fact that mutual funds are “sold” and not “bought”.\footnote{\textit{Supra}, note 158.} The very fact that mutual funds have to be “sold” indicates that we are here dealing with an uninformed market, and this has been borne out by \textit{The Wharton Study} which found a “lack of correlation between mutual fund sales and performance.” “If there were an informed market, you would expect mutual fund sales to be highly related to performance of funds. It is not. In our mutual fund study, (Wharton Study) which covered a multiyear period, we found a \textit{very weak link between sales and performance, but a very strong link between sales charge and sales}.\footnote{Emphasis added. \textit{Supra}, note 158 at 727.} Consequently, we have an upside-down competition where sales are increased by raising sales charges and adding to the sales force. The mutual funds, contends Professor Herman, do not compete through performance or the services they offer to consumers, but by gaining the favour of the dealers by offering higher sales charges, and through the medium of reciprocal brokerage. However, competitive markets should operate in terms of the selling of a quality product, on its merits, instead of training salesmen to sell a product without regard for its fundamental merit.\footnote{\textit{Id.}} The competition is thus ‘perverse’ in the sense that the salesman’s or dealer’s commission plays a more decisive role than the merit of the fund.

Herman decries the argument of those who claim that the mutual fund industry is competitive by virtue of the large number of funds currently operating. The emphasis, instead, should be placed on the importance of personal selling. When the buyer is confronted by the salesman, he is being offered one fund, and the fact that there may be 350 others is “quite irrelevant to the contracting process involved in personal selling, which often approximates what economists call a bilateral monopoly, with an imbalance in bargaining power between the skilled salesman, who knows what he is doing, and the relatively uninformed buyer.\footnote{\textit{Id.}}

The response offered by Report A would be to the effect that the solution for the uninformed investor is effective disclosure. Professor Herman avers, however, that the securities industry is already characterized by extensive disclosure, and he doubts that disclosure can achieve the type of objective, for example, that Report A sets out. Since materials, such as prospectuses, provide only the facts about a single fund, one cannot compare funds, and comparative disclosure would be very difficult to achieve.\footnote{This is a realistic approach, because it is unlikely that a mutual fund would provide compara-}
tive figures that would do anything other than show up that particular fund to its best advantage, and this type of disclosure would not truly inform the uninformed.

REPORT A: COMPETITION AND MUTUAL FUND PERFORMANCE

Since Report A places the burden of its solution on the merits of competition, one might believe that the essence of its proposal would be a system wherein competition is based on the fund's performance record, which, according to Professor Herman, would represent competition on merit. However, a careful examination of Report A, will indicate that a recurring theme is the playing down of assessments based on actual performance records of the funds. One may take a position as to whether past performance is an adequate guide to the prediction of future rate of return. However, it is difficult to contemplate a theory relying on competition, which pleads agnosticism as to the means of determining the quality of investment management. Since the very essence of the mutual fund is the pooling of money to pay for and obtain the best in professional management, one would infer from this that a prime consideration in a postulate of a competitive market, would be that aspect of the mutual fund which represents its very essence. As long as Report A plays down this aspect, the concept of informing investors, and developing competition becomes a mere receptacle, devoid of content and meaning.

Report A says, "In spite of its importance, quality of investment management is difficult to measure and may be impossible to predict."\(^{165}\) The Report rightly stresses the importance of relating a rate of return analysis of a fund, with the degree of risk it assumes. The Report, referring to an Analysis of Canadian Mutual Funds Based on Historical Rate of Return and Risk,\(^{166}\) states the following as the conclusions to be derived from this analysis. "Mutual funds with a high rate of return over one five year period tend to show a high rate of return over the following five year period, but the correlation is very weak..." The Report concludes that this would indicate that historical records of rate of return do not provide a good basis for prediction of future rate of return. Historical records however, do provide a good basis for predicting future risk. Tests combining 'risk and 'rate of return' "indicated a low level of predictability. This result casts doubt on the value of historical information in the prediction of the relative ranking of mutual funds on the basis of combined risk and rate of return."\(^{167}\) This suggests, very simply, that one cannot measure the quality of investment management by referring to past performance.

When Report A proceeds to discuss means of fostering competition by educating investors, it refers to the information that the various communications media would present, in order to enable the investor to compare the mutual funds. Report A would prefer that this information be essentially management fees and sales charges, but with no great emphasis placed on performance. The conclusion outlined in the above paragraph would apparently

\(^{164}\) Id. at 728.
\(^{165}\) The Report, supra note 1, at 61.
\(^{166}\) A study commissioned by The Report.
\(^{167}\) The Report, supra note 1, at 70, 72.
constitute the rationale for de-emphasizing past performance or any attempt to assess the quality of management. Report A says, "In paragraphs 3.08 and 3.16 we criticize the present practice of such newspapers in ranking mutual funds by rate of return over comparatively short periods. Analyses should be prepared which take other factors into account, including investment objectives, sales charges, and management fees."\(^{168}\)

The same tendency to obscure considerations of investment performance may be found in the recommendation of Report A to prohibit incentive management fees.\(^ {169}\) It appears contradictory for a Report, which wishes to rely on the free play of competitive forces to avert government intervention, to, at the same time, recommend a blanket prohibition of incentive fees. One of The Report's contentions is that the incentive fee, whereby the investment manager's fee is raised up to a certain maximum for performance superior to a specified index, and lowered down to a specified minimum for relatively poorer performance, is not at all necessary. This is because he is already rewarded for excellent performance because the consequent increase in assets will, in turn, increase the dollar value of the management fee. Report A then adds, "A less direct, but perhaps more important, relationship is that good performance ordinarily results in a higher volume of sales, thereby increasing total net assets and with it the management fee."\(^ {170}\) This proposition is somewhat doubtful, in view of the fact that growth in sales has been found to be more closely related to the level of the sales charge than to the record of performance.\(^ {171}\)

The Report finds serious problems inherent in an incentive management fee, such as that it will encourage an investment manager to take unnecessary risks with the mutual fund portfolio, in order to maximize the fee. It suggests a partial answer in the inclusion of a penalty provision in the event that the performance is below par. But, to use The Report's own logic, in the case of a fixed percentage management fee, the same problem exists, on the basis of the contention that good performance will increase management fees through increased sales. The Report cannot expect to employ both sides of the argument.

The Report deals with some of the serious technical problems involved in setting up an incentive fee clause that will be fair to the investor. These should, however, point the way towards regulation in place of total prohibition.

Report A places its faith in competition as a regulator of industry practices, but believes such competition ought to be fostered primarily in the area of sales charges and management fees, with a playing down of actual performance or rate of return. It is important, for a proper understanding of Report A to view the two emphases together, that is, competition and the insignificance of actual performance. These two emphases are contradictory. Competition, predicated on the basis of rate of return, represents to many small funds the only hope of competing with the large funds. The ability to sell

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\(^{168}\) Id. at 329.

\(^{169}\) Id. at 398-406.

\(^{170}\) Id. at 399.

\(^{171}\) Cf. supra, p. 642.
performance, and the possibility of gaining from an equitable incentive fee, provide the framework for some degree of ease of entry. Armon Glenn, quotes the manager of a new small American fund, who complains that it is difficult to compete with the large established funds in getting clients:

There's a real Establishment in the industry today—it's like trying to break into an exclusive club. A management company can sit on a half billion dollars and have no performance at all. But it's got the customers sewed up with contractual plans and brokers pushing the shares. It can make good money on a ½% fee. I'd go broke.\textsuperscript{172}

He wants the incentive fee, because he must accomplish through merit, what the larger funds achieve through high-pressure salesmanship. Henry Neuwirth, president of Neuwirth Management & Research Corp., said,

The only way a new fund can break into the business is through the gamble of a performance fee to be earned. This is also needed to attract capable management...\textsuperscript{173}

With the incentive fee, the small fund acquires the capacity to attract top-flight security analysts, giving it a hope of competing with the larger fund.

Thus, instead of blanket prohibition of the incentive fee, it would be preferable to regulate it so as to eliminate or at least vitiate possible abuses. For example, it would be most important to require that the incentive fee basis include a clause providing for an equivalent penalty to be paid by the fund, with a floor for the basic fee, and a ceiling for the top incentive fee. The result would be a sliding scale fee predicated on performance.

It should be noted that the incentive fee funds in the U.S. profited by the arrangement in 1968, but, generally, paid very heavy penalty fees for their poorer performance in 1969. For example, a well known mutual fund manager paid a penalty to the fund of $105,000 for the August fiscal year, while another paid $708,693 for its poor 1969 showing.\textsuperscript{174}

Quirin and Waters, as opposed to Report A, conclude that the incentive fee should not be prohibited.\textsuperscript{175}

In averting serious consideration of competition on the basis of rate of return, Report A avoids the Scylla of encouraging the investor to focus on the acid-test, the performance record of the fund, but then, runs aground on the Charybdis of justification for the very concept of a mutual fund together with the management fee. Report A assumes that it is not feasible to assess management in terms of predicting the rate of return of a fund, based on past performance, as an indication of the fund manager's investment ability. It apparently follows from this, that management really makes no significant difference. Thus, the 'random-walk' theory that an unmanaged diversified portfolio will do as well as, if not better than a managed portfolio of stocks with similar risk factors. Professors Renshaw and Feldstein say, speaking of investment portfolio performance:

Evidence that can be cited, indicates that the average return from professional

\textsuperscript{172} Heads We Win ..., Performance-Fee Mutual Funds Have Had Their Ups and Downs, Barron's, March 2, 1970, at 5.

\textsuperscript{173} Id.

\textsuperscript{174} Id. at 5, 12.

\textsuperscript{175} The Study, supra note 10, paper 1, at 12, 13.
advice and continued supervision is very low. In many cases it is zero or negative; in other words, investment companies as a whole have not outperformed representative stock averages which could form the basis of an 'unmanaged' portfolio.176

Professors Renshaw and Feldstein do not deny that some mutual funds have outperformed 'unmanaged' funds, but "these companies (the better performers) in the main have been offset by other companies which have performed less well than the major averages."177 This would tend to bear out the argument in favour of permitting incentive fees. Let those who do perform the service promised to the investor, as opposed to those who do not, be compensated accordingly, and let the light of publicity shine on those who perform a significant management service, as opposed to the many who do not.

Henry C. Wallich, Professor of Economics at Yale University, in a statement submitted to the U.S. Senate Committee considering mutual fund legislation, advocated a modified version of the 'random-walk' theory of stock price movements, and this led him to seriously question whether the mutual fund management companies were indeed earning their fee altogether, let alone the generous fees on the order of 9%. According to the 'random-walk' theory, the market price of the stock has already discounted everything that is already known, and the future price movement is unpredictable. Professor Wallich explains that:

... according to this theory of complete discounting of all that is known, and subject to the respective probabilities, neither research into the company, nor the industry, nor the whole economy, nor chart reading, would enable one to predict the next move, or any thereafter, better than a random guess.178

Professor Wallich says that studies by noted professors, including a Ph.D. dissertation, "have all shown that mutual funds on average do not do better and usually do worse than random selection."179 He concludes that the results of the investment advice of mutual fund management companies, not unlike all other investment advice, "are unlikely to do better than random choice, its value therefore very low or zero." Consequently, it is not meaningful to compare the level of mutual fund advisory fees with other fees. Instead, one should ask how far these fees are economically justifiable.180 Thus, the quality

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177 Id. at 490.
178 Supra, note 99, Senate Committee Print, at 1059, 1061.
179 Id. I. Friend, M. Blume, J. Crockett, Mutual Funds And Other Institutional Investors (Toronto: McGraw-Hill, 1970) is a follow-up to The Wharton Study, supra note 30, and its findings reinforce the 'Wharton' conclusions, while tending to support the general argument in this essay. Mutual Funds And Other Institutional Investors at 21 summarizes some of its findings:

When funds were classified by fund size, sales charges, management expenses, portfolio turnover, and investment objectives, no consistent relationship was found between these facts and investment performance properly adjusted for risk. To the extent that a relationship exists between performance and sales charges, the funds with the lowest charges, including the 'no-load' funds, appear to perform slightly better than the others .... In 1968-69, high management expenses and, to a lesser extent, high turnover seemed to be linked with poor investment performance.

180 Supra, note 99, Senate Committee Print, at 1062.
of investment advice offered does not justify the current level of fees charged. Professor Wallich does say that there are a few security analysts of extraordinary ability, but, "The average institution is unlikely to have them on its staff."\[^{181}\]

Is this the position taken by Report A? A positive answer to this question is doubtful in view of Report A's reluctance to control management fees. The Report cannot have it both ways. It cannot implicitly place a premium on the value of mutual fund investment management to the extent that fees for such valuable services may not be limited by regulation and at the same time, disparage a system whereby investors are encouraged to examine whether this service is indeed of value or not, in the form of an assessment of actual performance results.

**MANAGEMENT FEES AND SALES CHARGES:**
**AN INTERIM SOLUTION**

Report A concedes to Report B the interim solution for the control of management fees and sales charges, to last for five years approximately, and to be relinquished with the advent of a competitive milieu, even if that is prior to the end of the five year period.\[^{182}\] In essence, Report B would grant the securities administrator the discretionary authority to set the fees when the mutual fund is registered with the Securities Commission, or to deny authorization in the event of an application for a higher level of fees. The securities administrator would also have the authority to challenge an existing fee structure, and would consider the management fee and sales charge together. This would allow for flexibility in fee setting, with the administrator being able to make distinctions between various types of funds and their relevant costs, and would make for a management and sales fee arrived at through the process of negotiation between the mutual fund and the securities administrator. The proposal would grant the mutual fund the right to appeal a decision of the securities administrator to a Court, which would have the power not to set the fee, but to rule whether the fee that was fixed by the administrator was reasonable or not, and if not, it would in effect, be sent back to the securities administrator for revision, that is, to be scaled down. The Court would be guided by appropriate legislative guidelines, some of which are suggested in The Report.\[^{183}\]

*The Report* states that, "comparatively few judicial applications will in fact be necessary, for the initial applications will result in decisions that will constitute adequate precedents for subsequent use."\[^{184}\] If that is the case, then why the reluctance to establish a legislative standard at the outset? Since management fees and sales charges will, in effect, be set by well known judicial precedents, where is the much vaunted flexibility which *The Report* assumes will result from negotiations to be carried on between the mutual fund and the securities administrator?

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\[^{181}\] *Investment Company Amendments Act of 1969*, Hearings Before the Committee on Banking and Currency, United States Senate, Ninety-First Congress, at 146.

\[^{182}\] *The Report*, supra note 1, at 348-360.

\[^{183}\] Id. at 354-356.

\[^{184}\] Id. at 354.
Furthermore, in the event that it is achieved, the very flexibility that The Report wishes to introduce, by permitting different treatment for different types of funds, could result in discriminatory treatment of some funds, in the event of an uneven or unequivalent application of the Security Commission's discretionary power.

It may be suggested, that Report A, in allowing Report B to propose this interim solution, was merely granting it a hollow rhetorical victory. While the securities administrator may challenge the level of sales charges and management fees of a mutual fund which is already registered, it is doubtful that a Securities Commission would take the initiative in attempting to lower the rates. In effect, the proposal leaves us with the current rates, which appear to be excessive, and provides no assurance that the securities administrator will not approve increased fees. Of course, the Securities Commission could initiate a lower fee structure for the industry, by refusing to accept a prospectus unless it includes a reduction in fees. This is a possibility in view of the fact that a new prospectus must be filed after the expiration of a one year period, because the shares of mutual funds are offered continuously. But whether a Securities Commission would thus intervene is open to some doubt. One may assume that, given the effectiveness of the mutual fund lobby, and the weakness of the representation of the shareholders' or "peoples'" interests, a Securities Commission might tend to approve higher sales charges and management fees.

Report B itself indicates that this interim solution differs from the U.S. SEC position, in that the former leaves no room for a shareholder of a mutual fund to challenge the management fee, whereas the latter is predicated on permitting the shareholder to go to court to challenge the reasonableness of the management fee. Serious consideration ought to be given to a solution somewhat closer to the SEC proposals, with the 5% flat limitation on sales charges generally, and the statement of a legislative standard of reasonableness, designed to allow shareholders, as well as the SEC, or shareholders with the assistance of the SEC, to challenge the management fee.

Another alternative is based on strengthening the interim solution proposed by Report B, so that it will function fairly and equitably. The investor protection aspect of this proposal would be enhanced with the introduction of the adversary system in the rate-making decisional process. Thus, the decision as to management fees and sales charges would be made within the framework of public hearings, held by the Securities Commission, with the right of representation on behalf of shareholders of the mutual fund whose

188 The Report, supra note 1, at 353.
187 Supra, note 181; supra, note 33, House Committee Print at 30, 45. The Investment Company Amendments Act of 1970 (Public Law 91-547) represents an attenuated version of the SEC proposals. Among its major provisions, a mutual fund investment adviser is given a specific fiduciary duty, with the consequence that the SEC or a shareholder could bring an action to test whether the management fee is appropriate. And the Act provides that the National Association of Securities Dealers will regulate the level of sales charges, a form of self-regulation.
rates are being evaluated. The shareholders would be given standing before the securities tribunal, and could choose to be represented by counsel. The problem, however, remains, as to the ability of a shareholder group to finance counsel in order that their case be adequately presented to the tribunal, especially in view of the fact that the mutual fund would be drawing on the proceeds of the management fee to engage counsel. It would be helpful if provision were made for the mutual fund management company to pay reasonable costs for 'shareholders' counsel. Even if the latter could not be effected, the proposal itself would achieve a number of important objectives. It would move the decisional process from the 'back-room' into the public realm, where the 'interested' public could learn about the contentions being made on both sides of the issue. An administrative decision and a record of public hearings could be consulted. Furthermore, unless the mutual fund management company had a very strong case for an increase in fees, it would be reluctant to extend itself by initiating public hearings, with the attendant publicity and focus on the management fees and sales charges. The mutual fund management companies are reluctant to create a situation whereby public attention is focused on the management fees. The Report explains that the management companies have not raised their fees up to the currently permissible level, because "the necessity to notify shareholders and unit-holders of the increase would draw management fees to their attention as an important aspect of their operations."\textsuperscript{188}

In sum, this proposal would afford an opportunity to the shareholders to make their views known to the Securities Commission.

In order to avoid a multiplicity of hearings, some provision might be made, whereby, under certain circumstances, where adequate precedent has been established in public hearings, and other specified conditions precedent exist, that the Securities Commission would exercise a well-defined power to make a decision in the absence of public hearings. Perhaps, in that event, the Securities Commission would give public notice to that effect, and invite shareholders to submit briefs. However, if not properly administered, this proviso could mitigate the effectiveness of the entire proposal.

The right of the mutual fund to appeal an adverse decision appears to be a one-sided right. While the mutual fund can appeal, the opposing party, the shareholder, is given no standing to intervene before the Court. What is the right of the shareholders if they believe that the Securities Commission decision is against their interest?

Provision should therefore be made that when a Securities Commission passes on mutual fund management fees and sales charges, and the mutual fund management company reserves the right of appeal, it should be required to set aside a reasonable sum of money to allow for retention of counsel on behalf of the shareholders of that fund, so that they may appeal a decision which they view as being adverse to their interests, or so that they may use their standing before the court to oppose the mutual fund in the event that it decides to appeal the Securities Commission decision. Thus, all the interested parties, including the shareholders, will have an opportunity to present their views.\textsuperscript{189}

\textsuperscript{188} The Report, supra note 1, at 321.
REGULATION OF MUTUAL FUND SALESMEN

Report A emerges, with full force in the area of the regulation of salesmen, while Report B remains relatively quiescent in this area. Report A states the assumption at the outset, which will justify its attenuation of the present regulatory structure. The Report does not hesitate to concede that, "the scheme we propose, considered in its totality, would be less restrictive than the one presently in effect." This policy is based on the following premises. "In a free economy sales forces should be allowed to function unless some valid public policy motive is found for their abolition. We are aware of no such public policy motive." There is some measure of obscurity in this statement, because the issue appears to be regulation instead of abolition of sales forces, the latter not constituting a serious suggestion. However, The Report appears to be saying that, in its view, interference with the free function of the salesman, is akin to abolition.

It appears that when we are confronted with a need to intervene in order to protect the investor, The Report invokes the free economy concept whereas, when the question is one of protecting the interests of the mutual fund industry, such as penalizing a short-term trade in a mutual fund for over $50,000, or absolute prohibition of incentive fees, then Report A overcomes its reticence about interfering with the free economy!

There is indeed a very clear public policy motive for regulating mutual fund sales forces. Mutual funds call on peoples' savings and retirement funds, and, as The Report indicates, are a long-term commitment and are thus imbued with a special public interest. This is recognized in the concluding paragraph of the first section of the U.S. Investment Company Act, 1940, which speaks of eliminating conditions "which adversely affect the national public interest and the interest of investors." The investor must be protected from glib and high-pressure salesmanship. For example, the type of salesman who sells mutual fund shares by means of the technique indicated in the following letter from an investor, should either not have been selected for the position, or should have been more adequately trained to fulfill his responsibility to edify instead of looking only to the earning of a commission.

I am in a mutual fund called 'X' which is now $5.51 a share ($8.39 a year ago). I bought the stock on the suggestion of a salesman through a bank with the shares as security for a loan. Now, with prices down, the bank wants more collateral for the loan which I must supply or else sell the shares. What should I do?

The mutual fund salesman encouraged his client to engage in a reckless, costly speculative venture entirely inappropriate in a mutual fund context. The sales

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100 I owe the suggestions as to the Securities Commission Public Hearing proposal, and the granting of standing to the fund shareholders before an appeal court, in the event that the mutual fund reserves the right of appeal to Professor William A. W. Neilson, of Osgoode Hall Law School, York University, Downsview, Ontario. Any inadequacies in the definition of the proposals are my own.
101 The Report, supra note 1, at 511.
102 Id. at 492.
103 Id. at 398-406.
104 Ray Magladry, Borrowing Money to Buy Mutual is a Poor Investment, Toronto Daily Star, January 2, 1970 at 12. 'X' represents the name of the fund.
charge for the ‘X’ Fund is 9% and bank loans are generally in the area of 10%, which means that the fund share would have to rise 19% in value in order for the investor merely to break even!

The Porter Report recognized the problem in the low standard of selection and admission of mutual fund salesmen into the industry, as well as in the lack of adequate training:

Many mutual fund salesmen have had no experience in the securities industry, are working part time only, and are poorly-trained; moreover, the high rate of turnover of these salesmen has provided a chronic problem for the hard pressed securities administrators. One commission reported to us that the doubling of salesmen's registrations in the two years ending in 1961 was due almost entirely to the heavy influx of mutual fund salesmen.195

The Report would, in essence, move away from an emphasis on the selection and training process, to a system of control via “internal procedures established by the sales organization for the supervision of salesmen.”198 This is a form of dependence on industry self-regulation, which would tend to be inadequate, because of the degree of self-interest in maintaining a high-level of sales on the part of the sales organization, and a reluctance to undertake measures which would have the effect of reducing sales. Another problem is that this solution creates a facade of regulation, when in fact, there is no viable and enforceable system of regulation in operation.

In Ontario, newly registered mutual fund salesmen are required to take the Canadian Mutual Funds course, sponsored by the Canadian Mutual Funds Association.197 Report A has reviewed the course, and has “concluded that, while far from an intensive analysis of the industry, it is adequate for the purpose.”198 This conclusion is open to question. It should be noted that the Canadian Mutual Funds Association is an association of mutual funds, and it is in the interest of the members of the CMFA that a large number of salesmen are qualified by the examination, because they are their principle instrumentalities for earning a profit. It should be appreciated that the CMFA represents only certain mutual funds, namely those funds which are sold subject to a basic sales charge which exceeds 8%. The CMFA membership consists of only 41 of the 136 mutual funds qualified for sale in Canada; and most of the 41 funds are distributed “primarily or exclusively through direct sales forces.”199 The latter, especially, would indicate the pressure which the

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195 Supra, note 5 at 353.
197 Id. at 514.
198 Id. at 515.
199 Id. at 727, 728. The data in the text as to the CMFA is current as of the date The Report was issued. Cf. CMFA adopts major rule changes, The Globe and Mail, Report On Business, May 23, 1970, at 2, in respect of changes in the CMFA constitution, by-laws, code of ethics and regulations, designed to attempt to implement some of The Report's recommendations; among them, that the CMFA become a more representative organization. Cf. CMFA takes giant strides, hesitates on other big issues, The Globe and Mail, Report on Business, May 29, 1970, for a contention that the changes then adopted by the CMFA were among the simplest of those recommended by The Report.
member mutual fund would place on the CMFA that a sufficient number of salesmen be qualified. In this light, it is difficult to understand how Report A could assess the adequacy of the CMFA course and examination, when it fails to indicate that it received information from the CMFA as to the failure or rejection rate of those enrolled in the course and taking the examination.

The CMFA course is comprised of four units of programmed materials:
Unit I—An Introduction To Mutual Funds;
Unit II—The Fundamentals of Investment;
Unit III—How Mutual Funds Operate;
Unit IV—The Services Of Mutual Funds.

The material is very elementary and demands little of the sales candidate. Furthermore, the emphasis appears to be centred on developing sales techniques and giving the salesman just enough knowledge about mutual funds to enable him to employ high-pressure sales techniques, such as playing on the fear of inflation, and warning people that their ‘dollar’ savings will have turned to ‘nought’ when retirement age is reached. An examination of the course materials will reveal that they fail to place sufficient emphasis on the attainment of a comprehensive and thorough knowledge of various investments, which could enable salesmen to place mutual funds in their proper context, and to understand the underlying ingredient of mutual funds, namely shares of stock; and most certainly not enough to qualify salesmen to hold themselves out to the public as ‘financial planners’.

Perhaps the philosophy of the CMFA with regard to its training program, is best summarized by its submission to The Report, where it said, “A salesman does not need to be an amateur investment analyst—he has only to know what his product is and how it can be used.”

There is reason to believe that the industry or the sales organization would prefer a salesman who knows very little about investment analysis, so that he will not be burdened by the ‘facts’ in his sales talk, nor inhibited by considerations of prudent investment policy in his recommendations. Allan Conwill, Director of the Division of Corporate Regulations, SEC, said that a mutual fund executive told him ‘that he will not hire a salesman who has any knowledge of the securities business because it will divert him from a proper sales approach.”

Conwill comments wryly, “Apparently even a lot of securities knowledge is a dangerous thing.”

There is every reason to believe that a comprehensive background in understanding securities, as such, is critical in gaining an understanding of mutual funds, for mutual funds are nothing less than securities packaged in a certain way in the context of a particular portfolio.

200 The Report, supra note 1, at 510.
201 Such as recommending ‘front-end load’ or contractual plans, which, as we have attempted to indicate supra, pp. 615-619, are suitable for no one, except for the salesman, who receives his commission in advance, for the ‘uninvested’ portion of the fund sale.
The Report indicates that one may be qualified to sell mutual funds, if he will "pass the Canadian Securities Course, a more extensive and difficult course designed for those who propose to participate in a general brokerage business."\textsuperscript{203} It is reasonable to expect that the mutual fund salesman who frequently deals with those who are less sophisticated than the individual who has the ability to manage his own portfolio, should be expected to conform to as high a standard as the stock broker, or registered representative. Gopman has stated his belief, which he indicates to be partially proved by the SEC's \textit{Policy Report}, "that those who invest in investment companies are financially less sophisticated than those who use other investment media."\textsuperscript{204}

The Report rightly questions the fact that a sales candidate is presently permitted to commence selling immediately upon passing a very easy preliminary examination, and has a period of up to a year during which he is permitted to sell mutual funds prior to passing the final examination. The Report would reduce this period, but still allow an interim period of 3 months of selling prior to full qualification, in the case of a full time salesman. The reasoning is that he be permitted to sell fund shares for 3 months, instead of having to wait till he is fully 'qualified', because he requires the income to support himself.

The Report says, "It would be necessary for the applicant to be supported while he was engaged in his studies, and the addition of the expense which this would require to that already necessary for registration fees and the costs of the Canadian Mutual Funds Course might well raise to an uneconomic level the initial financial burden involved in becoming a salesman." It appears that The Report has found that mutual fund sales organizations do not compensate salesmen during the interim period prior to full registration, and that they do not even pay some of the basic fees incidental to full registration, and that they should not be expected to do so. Thus, the initial registration period, for at least 3 months prior to taking the examination during which time the salesman is permitted to sell fund shares, will be retained.\textsuperscript{205} In disposing of the issue of registration to sell prior to full qualification in this manner, The Report has missed an important opportunity to recommend a significant reform, as will be suggested below.

There is considerably more need for reform in the qualification of sales personnel than The Report would concede. Report B is permitted to briefly assert itself, when it stresses that the sales organizations should strive to exclude the salesmen "who will remain for only a short period." Report B continues:

\begin{quote}
These salesmen tend to effect sales only to their family and friends before realizing that they are not qualified to continue as salesmen. They lack the feeling of long-term commitment which is so essential for all participants in the securities
\end{quote}

\textsuperscript{203} The Report, supra note 1, at 514.
\textsuperscript{204} Regulation of Mutual Fund Selling Practices (1969), 24 The Business Lawyer, 409, 419.
\textsuperscript{205} The Report, supra note 1, at 516. OSC-Policy #3-06, Examination Program For Salesman, April 5, 1971

(2) Salesmen applying for registration to sell mutual funds exclusively must complete the mutual fund course and pass the final examination within three months of being granted probationary registration.
industry. They do not provide adequate continuing service for their clients, and they often do not receive adequate training and experience.206

This represents merely another rhetorical triumph for Report B, for Report A concludes that applicants for registration as salesmen should not “be required to satisfy any preconditions in addition to taking and passing the training course.”207

We suggest that a comprehensive statement regarding standards for the acceptability of a candidate for registration as a mutual fund salesman should be incorporated either in a policy statement issued by the Securities Commission, or adopted by an effective self-regulatory body; and that it should be along the lines of the following statement in the New York Stock Exchange Rules with reference to Registered Representatives:

2345.15: Acceptability. — In determining a candidate’s acceptability for registration the Exchange looks for evidence of:

(1) The integrity of the candidate and his record of high standards of business conduct, as shown in the investigations and observations of his member firm employer, previous employers, educational institutions attended, etc.

(2) His potential ability to perform creditably the duties of a registered representative, as shown by an employment period of specific training for these duties in a member firm office or equivalent other experience in the securities business.

(3) His preparation in the areas of knowledge necessary for a registered representative as demonstrated in an Exchange examination.

The following section deals with the requirement that the training period be for a duration of six months. During this period he is to be engaged in formal study, and is not to solicit business. Under 2435.17 of the NYSE rules the Registered Representative’s agreement is set out whereby he undertakes to comport himself according to the Exchange standards, such as subjecting himself to Exchange discipline, if he has been guilty of, for example, conduct inconsistent with just and equitable principles of trade.

Section 2435.15 (1) is effectively implemented:

2435.19: Investigations and Records — Members and member organizations should make a thorough inquiry into the previous record and reputation of persons they contemplate employing.

The background and reputation check should whenever possible include at least personal conversation with all employers during the previous three years and verification before or promptly after employment of business history for the previous 10 years...

In the case of proposed registered representatives, the Exchange makes the 10-year verification check as a service to member firms, but the check of employers during the last 3 years is a member firm responsibility.208

The Toronto Stock Exchange does not have a similarly elaborate set of standards for registered representatives. However, sec. 8.35 of the TSE By-laws provides:

All Approved Persons and employees of members shall comply with the Exchange Requirements. Each member shall ensure that all his employees, directors and officers, and all the partners in the member firm comply with Exchange requirements.

206 The Report, supra note 1, at 517.
207 Supra, note 205.
208 NYSE Constitution and Rules, 1968, CCH.
This then serves to bring the registered representative under the very strict disciplinary provisions of sec. 17.10, which speaks of "contravening any Exchange Requirements" or being

"guilty of any conduct proceeding or method of business which the Board in its absolute discretion deems unbecoming a member or Approved Person, or inconsistent with just and equitable principles of trade, or detrimental to the interest of the Exchange or the public: ..."209

These are models for a statement of prerequisites for employment, and standards of conduct which any provision for the regulation of mutual fund sales personnel should look to, whether, through the medium of effective self-regulation, or by means of the Securities Commission itself. Anything less than such a standard, which would call for provisions for effective enforcement, that is, through disciplinary action, would be a disservice to the public.210 Furthermore, the six month training period without authorization to sell securities, in the NYSE regulations, has a great deal of merit. It has impelled many stock brokerage firms to pay the trainee a salary during this period.

Against this background, it is surprising that The Report, in allowing the full time salesman to be registered to sell during the three months preceding full qualification, does so to enable the candidate to support himself during the interim period. The Report fails to consider the alternative that the three month interim period be eliminated under the assumption that the sales organization would undertake to fulfill its obligation to the salesman by supporting him during this period. We suggest that this would be a positive result.

It is not merely that, by right, the burden of supporting the salesman for a time, ought to be borne by the sales organization. Firstly, during this interim period, the aspiring salesman should be viewed as a bona fide 'trainee' and ought to devote his efforts to the learning process instead of to the solicitation of sales. If indeed this duration of time, whether 3 months or 6 months, is not required in order to prepare the salesman for the CMFA examination, then our suspicions are again confirmed, to the effect that the examination lacks the requisite degree of intensity. To reach this objective, of making the interim period a true 'training' period, the CMFA examination should be made more rigorous so that the sales candidate will be compelled to engage in studying instead of in selling. It is suggested that the period of training for full time salesmen be extended for six months, without the candidate being registered for selling, and that the sales organizations be encouraged to provide the candidate with adequate support during this period.

This would achieve a second purpose, in that there is a positive value in having a sales organization make an 'investment' in a salesman. Once the hiring of a salesman entails an expenditure, in the absence of immediate sales

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210 The Report, supra note 1, makes no specific recommendations as to a code of conduct for salesmen and for admission standards, and even appears to deny the need for a code and for such standards, Cf. supra, p.116. If, however, The Report, at 731, No. 2 re conditions for a self-regulatory organization, assumes that the self-regulatory organization will be responsible for a code and admission standards, this should be articulated.
production, the sales organization will tend to select its salesmen with a view to a long-term commitment. Report B suggests this as an objective, but Report A fails to offer any proposals designed to achieve it. The U.S. Special Study reports that mutual fund salesmen have the highest rate of turnover in the securities business.\textsuperscript{211} The training period proposal is one way to cope with the problem. There is reason to believe, presently, that the high turnover of mutual fund salesmen, is due, in part, to the fact that it is relatively easy and cost-free for the sales organization to hire a large number of salesmen.

However, if the sales organization were placed in the position where it would be compelled to make a meaningful expenditure in the course of engaging salesmen, and would be expected to establish programs designed to offer training in something more than sales gimmickry, it would be far more selective in its hiring procedures than is currently the case. Additional requirements relating to the provision of sales training courses should be set. This, together with an adequate training period, lasting at least six months, during which time the trainee would not be authorized to sell fund shares, would compel the sales organizations to make an 'investment' in each salesman, and they would therefore approach the 'hiring' task with a higher degree of responsibility. Thus, there is much merit in raising the level of selection and training of mutual fund salesmen to that of registered representatives of stock brokerage firms.

PART-TIME SALESMEN

The Report opposes any restriction on the hiring of part-time mutual fund salesmen, on the ground that the quality of sales is dependent more on the character of the individual, than on the amount of time he spends performing a service, and also, on the principle that this is simply a matter for industry to determine for itself.\textsuperscript{212}

Report B does assert itself as to the reasoning which is used to negative part-time salesmen, such as, the difficulty in disciplining and the lack of long-term commitment, but again, Report A emerges victorious.\textsuperscript{213}

It is interesting that this question of part-time salesmen is related to the above discussed issues as to the compensation of salesmen during the interim period prior to full registration. The Special Study indicates that the sales organizations prefer to engage part-time salesmen, because they do not wish to compensate salesmen during a 'training' period or provide them with an advance 'draw' on commissions. The Special Study, on the basis of statistical data, concludes that most mutual fund organizations cannot claim that even half of their sales force works full time in the area of mutual fund sales. "In the aggregate, the sales forces of firms specializing in the sale of mutual

\textsuperscript{211} Report of Special Study of Securities Markets, Part I, at 96, 97. The material developed by The Special Study, regarding deceptive practises of mutual fund salesmen, should be carefully considered.

\textsuperscript{212} The Report, supra note 1, at 525.

\textsuperscript{213} Id.
funds were shown by the STS (statistical survey; Screening, Training and Supervision) responses to be composed of about 66 percent part-time salesmen.\textsuperscript{214}

The willingness on the part of Report A to encourage the hiring of part-time salesmen is consistent with its acceptance of a low standard of salesmen selection and training, in that, it is satisfied with nothing more than a very minimal CMFA course requirement. Given the assumption that there is no ground or need for insisting on any serious degree of professional standards and requirements for entry into the salesmans' position, it follows that part-time salesmen will be just as capable of carrying out the minimal tasks expected of mutual fund salesmen as will full-time salesmen.

Part-time salesmanship is inconsistent with the requisite degree of professionalism which asserts that the salesman be well-informed and capable of educating his clients, and offering guidance on the basis of an intelligent understanding of the best available information. The mutual fund salesman, like the stock broker should be viewed as a full-time professional who employs his time to educate himself, analyze the state of the securities markets, etc. Both the rules of the New York Stock Exchange and the Toronto Stock Exchange, require that securities salesmen devote themselves to the securities business on a full-time basis.\textsuperscript{215}

Failure to apply the same standard to mutual fund salesmen as is currently applied to stock brokers, would be to lend credence to the conviction that 'anybody' can be a mutual fund salesman, regardless of how little time he is prepared to devote to the carrying out of the salesman's responsibilities. A part-time salesman, we fear, will be tempted to apportion a disproportionate amount of time to actual selling, with too little time remaining for servicing clients' accounts, studying various 'plans', and assessing the particular fund or fund 'plan' which is best suited to his client's needs.

**CALLING ON RESIDENCES**

Report A calls for the exemption of mutual fund salesmen from section 67(2) of the Ontario Securities Act, 1966, which limits the authorization of securities salesmen to call on people at their residences to certain specified instances, such as where the prospects are close friends or relatives, or in the case of those who had requested in writing that information be supplied to them regarding the security being offered for sale.

The Report suggests a number of reasons for exempting the mutual fund salesman from the 'calling on residences' prohibition.\textsuperscript{216} Its effect is said to be particularly onerous on the mutual fund salesmen, because their arch-competitors, life insurance salesmen, are not subject to such a restraint. Again, a tendency on the part of Report A, to prefer to bring mutual fund

\textsuperscript{214} Supra, note 211, Part 4, at 116.
\textsuperscript{215} Supra, note 208, s. 2346, Rule 346; and supra, note 209, By-Law 8.10.
\textsuperscript{216} The Report, supra note 1, at 552-55.
salesmen down to the low level of insurance salesmen, instead of raising them to the relatively higher standard of the securities salesman.\textsuperscript{217}

It should be emphasized that to remove the limitation on a sales approach, in the case of a mutual fund salesman, while leaving the restriction to curb securities salesmen generally, will prove to be unfair to the latter. It should be noted that in terms of the nature of the product offered for sale, the mutual fund is more akin to the share of stock, than to the life insurance policy, which is generally viewed in the light of savings and protection.\textsuperscript{218}

In fact, the result of Report A's recommendation would be a particularly unfair one, when viewed against the background of the fact that the securities salesman is the one who has met the more rigorous requirements and standards. Yet, the less adequately trained mutual fund salesman is permitted to roam through private homes in his quest for sales.

\textit{The Report} also contends that such a prohibition is difficult to enforce, and that many mutual fund salesmen ignore the prohibition and few are reprimanded for it.\textsuperscript{219} Lax enforcement procedures, however, constitute a poor rationale for repeal. The difficulty of enforcement should not be made the touchstone of the legitimacy of a statutory standard. It would be preferable to assess the statute on its essential merit. Since \textit{The Report} itself proposes a scheme for closer supervision of salesmen on the part of the staff of the sales organization, this prohibition may be added to the staff's responsibilities.\textsuperscript{220} This comment is not predicated on any great faith in the willingness of the staff, under \textit{The Report's} proposals, to successfully supervise, but is only pointed out for the sake of suggesting the possibility of enforcement within the set of assumptions made by \textit{The Report} itself.

There is reason to believe that securities salesmen look upon the section 67(2) prohibition with more seriousness than do the mutual fund salesmen. The difference lies in the fact that mutual fund salesmen, because of ease of entry into the salesman's position and lack of long-term commitment to it, may not be as concerned about infringing a statutory prohibition, and jeopardizing, what they may view as, at best, a tenuous kind of a 'career'. Stock brokers, with the requirement that they be full-time employees, have a greater measure of commitment. Because of this, and the more rigorous standards they must comply with to gain entry into the industry, they have more to lose in chance of a violation. This point would also lend credence to our contention that part-time salesmen are a detriment to the object of fostering professionalism in the mutual fund salesman.

The benefits of retaining this prohibition by far outweigh any difficulties it imposes on some. On the theory that a man's home is his castle, he deserves to be protected from salesmen who are 'inspired' by the generous level of mutual fund commissions, to knock on his door or ring his telephone, and

\textsuperscript{217}Cf. generally, J. Gollin, \textit{Pay Now, Die Later} (New York: Random House, 1966) for a discussion of the high-pressure sales techniques employed by life insurance salesmen. Many of Gollin's criticisms are applicable to the mutual fund industry.


\textsuperscript{219}\textit{The Report, supra} note 1, at 553.

\textsuperscript{220}Id. at 526-530.
thereby invade his privacy. There is good reason, in the case of securities and mutual funds, to protect a person, when he is in his dwelling house, where he may be more easily persuaded to make an investment that is unwise for him. He is less sales-resistant in the atmosphere of his home, where he may decide not to resist the salesman, but to go along with him, so that, in the presence of the members of his family, he may not appear to be outwitted by a salesman who has been trained to anticipate his objections to mutual funds, with glib assurances. The mutual fund salesman can apply the same ‘fear’ and ‘scare’ tactics that life insurance salesmen have been known to employ with such deadly effectiveness. For example, he may persuade a man to buy a ‘contractual plan’ by pointing to the children or portraits of the children in the living room, and reminding the parent of his duty to provide for their future, and build an estate in order that the children be cared for in any eventuality. Mutual fund salesmen ought not be permitted to indiscriminately enter peoples' homes and use the home setting to stage emotional appeals, where rationality would dictate a course for the investor which is different from that suggested by a commission-seeking salesman.

It should not be forgotten that the salesman, under sec. 67(2) of the Securities Act, 1966, may approach certain categories of people in their homes, and that sales literature, which includes a 'response-coupon' may be circulated by mail to certain neighbourhoods the salesman would like to ‘cover’. The responses would likely constitute the written requests for information that would allow the salesman the right under the statute to call at the business or place of employment of the prospect. This is sensible, because, in his office, a person tends to be more businesslike in his response, and might be more inclined to make a rational decision when confronted with an investment proposal. It is conceded that many individuals will not have offices where they may be visited. But, these would tend to be lower-income groups, those who are less well-educated, who need the protection from the door-to-door salesman more so than others.

The Report suggests that perhaps this prohibition against calling on people other than friends or relatives in their residences, is a reason for the high turnover of mutual fund salesmen who sell to friends and relatives successfully, because they may interview them in their homes, but since they cannot sell to others in this manner, their sales careers are nipped in the bud. However, the reason for the high turnover of salesmen, lies at the doorstep of the sales organizations who hire salesmen on the basis of considerations other than high standards and qualifications. It is believed that many engage salesmen indiscriminately, with the intention, at the outset, that the salesman will bring in essentially the business of his friends and relatives, and not very much more. In the U.S., in the absence of the prohibition with regard to calling on residences, the same problem of high turnover continues to exist. The Special Study bears out this contention, when it indicates that many salesman, after selling to friends and relatives, and earning little more than $20 a week, leave the business.

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221 *Cf.* *supra*, p. 615 for discussion of the contractual plan.

222 *The Report, supra* note 1, at 553.

223 *Supra*, note 211, at 114.
The Special Study mentions a manual advising sales organizations to search for salesman who have experience in door-to-door selling, such as those who have been selling cosmetics, storm windows, and food freezers. Gopman, citing from The Special Study, asks the pertinent question — "Should securities be sold in the same manner as Fuller Brushes?" Gopman also indicates that The Special Study "concludes that NASD and the SEC cannot hope to control high-pressure selling since the sales pitch usually takes place orally in the home." Why should we be willing, in Ontario, to lower the standard, and add to the problem of high-pressure salesmanship, by relaxing the sec. 67(2) prohibition, and inviting the door-to-door mutual fund salesman?

It is interesting that The Porter Report endorses the 'calling at residences' prohibition, together with its application to mutual fund salesmen. "We wish to support the continued need for such legislation, including that aimed at mutual fund salesmen, to prevent the harassment of the public."

CONCLUSION

It is apparent that the recommendations of The Report, not only fail to give relief in the case of exceedingly high sales charges and management fees, but hold out the possibility that these will be increased in the future. The Report not only fails to raise the standards of salesmanship, which it believes currently to be of an edifying nature, but would even remove a positive restraint which now exists.

One may hypothesize that Report A represents the triumph of a successful lobbying effort on the part of the mutual fund industry, and Report B, the articulate struggle of those who would want to offer recommendations designed to effectively protect the public in an area where it is in dire need of protection.

In evaluating The Report's recommendations, it is helpful to consult the work produced by the SEC, such as The Wharton Study, The Special Study, The Policy Study, as well as the submissions of the SEC, professors and economists recorded in the various Congressional Committee Reports. Thus, the conclusions will be the result of an assessment of varying viewpoints, approaches and policies.

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224 Id. at 115.
225 Supra, note 204, at 413.
220 Id. at 414.
227 S. 67(2) of the Securities Act, 1966, but s. 53 of the Securities Act, as it was in 1964.
228 Supra, note 5, at 353.
The Report is indeed an impressive document, comprehensive in its grasp of the nature of the mutual fund industry and its peculiar problems, and profound in its search for solutions. It is characterized by felicity of expression, while, at the same time, careful and precise in its analysis. The Report is a great achievement, reflecting careful research and meticulous scholarship. It deserves nothing less than the most intensive study and consideration. Given a reflective and carefully reasoned response to The Report, the result will be a regulatory framework designed to encourage confidence in an honest and competent mutual fund industry, and to provide the protection which the public expects and well deserves.