MEMORANDUM

November 20, 1967

TO: The Commission

FROM: Irving M. Pollack, Director, Division of Trading & Markets

RE: Give-Ups: Alternative Courses of Action

We submit, for the Commission's consideration, two alternative approaches to deal with the "give-up" problem.

The first approach involves a disciplinary action against the managers of certain investment companies who have used give-ups to motivate and reward dealers for selling fund shares rather than for the benefit of fund shareholders. The Division has attached a memorandum outlining the basis for our case -- it is premised on a breach of fiduciary duty by the investment company managers for not recouping portfolio commission for the benefit of its fund shareholders. It is the Division's position that the investment managers of these funds could have made use of current market practices and procedures to return such commissions to their shareholders. As our memorandum points out, investment company managers have agreed that they could have taken such steps and reduced the portfolio expenses to their shareholders but that they either "did not think of it" or would be placed at a competitive disadvantage if they had unilaterally decided to embark upon such a course. The Division recognizes that the selection of fund managers against whom to bring proceedings under the Securities Exchange Act of 1934 end the Investment Advisers Act of 1940 involves some selectivity since the breach of duty giving rise to our complaint might be claimed against virtually all fund managers and not restricted to those against whom proceedings are recommended. On the other hand, the specific practice described in the memorandum is particularly egregious and points up the ease with which fund managers could recoup give-ups for the benefit of their beneficiaries. Further, the announcement of a disciplinary proceeding is likely to produce immediate salutary results toward resolving the "give-up" problem.

A second approach is set forth in a proposed rule and release which are to addressed to the same issue: the prohibition of give-ups directed by investment company managers other than those which inure to the benefit of the fund shareholder. The Division has couched the rule quite narrowly; it is designed to permit the regional exchanges to offer a useful service in the securities markets and to lower the costs to investors who purchase mutual funds. The Division's position is consistent with the argument of the New York Stock Exchange and other exchanges that the problem is essentially one which concerns investment companies and, accordingly, we have directed the thrust of our rule to that segment of the financial community. While we appreciate that there are some give-ups which occur other than in the investment company industry, and while a full-blown revision of the commission rate structure of the New York Stock Exchange might also deal with the problem, we think that the proposed rule is a meaningful way to deal with the problem. The Division believes that no exchange will unilaterally deal with the problem and Commission action is necessary in this area. Similarly, we do not believe that any mutual funds (except those with captive selling organizations) will voluntarily deal with the problem. [Footnote: In this connection, Marvin Schwartz (Sullivan and Cromwell), counsel for one of the advisers, commented:

"I can say on behalf of our clients that if the staff or the Commission ever advises that the Commission or the staff considers it improper for a trustee or manager not to make arrangements to return to the fund any give-up which is now allocated to over-the-counter dealers, then it will take steps to comply.

It is not for a moment giving any consideration to testing it in an enforcement or any other kind of proceeding, so when you say to us that the staff considers this an improper practice, it will be stopped, but I urge you to consider that this is not something which concerns one fund, or just a few funds, the question of give-ups via the regional exchange and this arrangement with Stifel is not something that Keystone started, it was in existence for many years before Keystone followed the practice.

And what would happen if any one fund stopped it today would be that it would be operating under a very severe competitive disadvantage; that it would find its dealers would turn to other funds which were not so willing to comply immediately with suggestions of the staff.

So then what I urge, and I think my clients would agree with me, is that if the staff or the Commission ever reaches the point that it has firm views on this subject, particularly if those views are negative, that they be embodied either in a regulation or in a simple release which will just tell the world this is what they think the duty is in this area. Then if it is stopped, every fund stands, and every manager stands on essentially the same footing.

I think if this practice is widespread, and from what you say, it obviously is, that it would be unfair to single out particular funds for any reason, and that the appropriate and fair way to go at it is either by regulations or by release so that everybody is then on the same footing."]

Accordingly, we submit to the Commission two approaches: one, an enforcement proceeding -- the other, a rule under the Exchange Act, both of which are directed to the duty of fund managers. The Division believes that either of them provide a way to meet the problem though, as a matter of public policy, there are considerations which night weigh in favor of one rather than the other which the Division would like to explore with the Commission.

Attachments

TO: The Commission

FROM: Division of Trading and Markets

SUBJECT: Practices and procedures of mutual funds in allocating brokerage -- a basis for enforcement proceedings

BACKGROUND

In the last few years, the Commission has received detailed information on various techniques developed by mutual funds to provide distribution channels through which they are able to allocate brokerage generated by portfolio transactions to dealers which are non-exchange members. These devices and arrangements, until recently, utilized the vehicle of regional exchanges which allow give-ups to non-exchange members which are either on a preferred list or members of the NASD. The give-ups are accomplished almost exclusively through the medium of portfolio executions on the NYSE by dual members with a concomitant give-up to designated NASD recipients on unrelated transactions by the dual member executed on the regional exchanges, or by direct portfolio execution on the regional exchange. A recent inspection of the New York Stock Exchange by the Office of Regulation has disclosed that a number of funds are now participating in an arrangement whereby they are able to use commissions generated by their executions on the New York Stock Exchange to stimulate give-ups to NASD-only dealers without the necessity of regional exchange trading.

Inasmuch as this arrangement represents a significant departure from previous devices employed by funds to reward broker-dealers for sales, the Division requested and received a formal order of investigation in order to explore the full ramifications and legal implications of this method of brokerage allocation. In the course of its investigation, several participating funds and broker-dealers have been interviewed and testimony taken. A significant amount of documentation has also been obtained.

THE ARRANGEMENT

In general terms the plan operates as follows:

Participating mutual funds employ a select number of New York Stock Exchange member firms to execute portfolio transactions in listed securities on the New York Stock Exchange. These firms, which we shall designate as lead brokers, are chosen primarily on the basis of their ability to obtain execution and provide incidental services to the fund. The funds direct their lead brokers to give-up 50-75% of the commissions earned on these transactions to another New York Stock Exchange member firm, whom we call a conduit broker. The conduit, in turn, agrees to distribute an amount equivalent to 50-60% of the give-ups it receives to NASD-only firms and in such amounts as the fund shall designate. It retains the balance as a fee for acting as the conduit or "banker."

The conduit firm, although it distributes cash, identifies the cash as originating from some account other than the NYSE commissions which it receives from the lead brokers. It creates an expense account for distribution of cash to the designated NASD dealer which is tied to unrelated over-the-counter transactions. The conduit broker purportedly gives-up from that account, an amount equivalent to 50-60% of the aggregate amount received from the fund's lead broker.

A brief example may be useful to explain the specific mechanisms of the arrangement. For the purpose of clarity, the steps have been set out seriatim.

1. X fund employs lead broker Y to execute a portfolio transaction on the NYSE. The Commission charged is $20,000.

2. Lead broker Y is directed to give-up $10,000 or 50% of its commission income to another NYSE member firm, Z, who will serve as the conduit broker.

3. X fund advises the conduit broker Z that he will receive $10,000 at the fund's direction. Of this amount, X fund directs the conduit to give $1,000 to five designated NASD-only members (an aggregate amount equaling 50% of the give-up received from the lead broker).

4. Conduit broker Z compiles a list of his over-the-counter business (both principal and agency business) setting forth the security purchased or sold, the price of the security and the date of the transaction. He then computes 50% of what a commission would be on the trades -- (some are principal trades).

5. The conduit Z sends separate lists of these OTC transactions to the designated NASD-only members. Each list contains exactly the number of transactions sufficient to produce income equal (at 50% of the commission rate) to the amount which the conduit has been requested to give-up. (An example of this list is attached for your reference.)

6. By oral arrangement, the recipient NASD firm agrees to return the list under its letterhead to the conduit with a cover letter stating that the firm has "this date debited [the conduit's] account with one half of the New York Stock Exchange commission on the enclosed list of trades." Despite the obvious implications of this procedure, the NASD-only member has not participated in any way in these over-the-counter transactions. The NASD member was not even aware of them until it received the "list." And no entries are made on either the conduit's or the NASD-only member's books which indicate that the recipient firm has participated in these trades.

7. Upon return of the list from the NASD-only member, the conduit broker merely sends a check in the designated, amount; in this case, $1,000 to each recipient.

The arrangement, described above, was apparently first devised by John Bunn, Executive Vice-president of Stifel Nicolaus, an NYSE and NASD member firm. Mr. Bunn, an official of the NASD, first obtained oral approval for the plan from that association. He then presented his plan to the New York Stock Exchange's Department of Member Firms to determine whether the arrangement would violate the Exchange's anti-rebate rules, he was informed, again orally, that the Exchange would offer no objection to this device.

This was confirmed by our discussions with NYSE staff. It is the Exchange's position that it cannot apply its rules to prohibit or control the actions of its members in other trading markets; in this case, over-the-counter transactions. It is obvious however, that the Exchange did not want to prohibit a give-up arrangement which utilized NYSE executions if at all possible. As a practical matter, the Stifel Nicolaus plan represented a means whereby mutual funds which desired to benefit NASD-only members would not be forced to regional exchanges or, in cases where give-ups were impossible on the regionals, to the third market. [Footnote: At a meeting with other member firms in January 1955, John Bunn indicated that the Exchange approved the arrangement primarily to discourage funds from going to the third market. The notes taken by Peter Barnes of H. O. Peet at this meeting are reproduced below:

Duke Jones
Harold Shutz

1/2 only to NASD member or non member.

If dont due [sic] it Funds will go to 3rd mkt, instead of executing on NYSE; ... NYSE likes it.

Agency or principal O.T.C. but must be with members of NASD -- no underwritings -- but OK in secondary mkt.

We pay out 50%]

THE SYNDICATE

In late 1953, Stifel found that its volume of over-the-counter transactions was not large enough to generate sufficient OTC commissions to accommodate the payments being directed by the funds. As a result, Stifel was forced to return a portion of the directed give-up to the lead brokers. In order to avoid a recurrence of this situation, Stifel requested and received from the New York Stock Exchange staff permission to form a syndicate with three or four other NYSE member firms to pool their over-the-counter transactions so as to provide a sufficient volume of "commissions" from which to identify the cash payments to satisfy the give-up instructions of the funds.

Pursuant to this plan, the syndicate member would send to Stifel a list of his over-the-counter transactions; designating whether he bought or sold, with whom he dealt, at what price and on what date. Stifel would use this list as if it represented his own transactions. The NASD-only member would not be advised that the transactions were, in fact, executed by someone other than Stifel Nicolaus. He merely would return the list under his own letterhead as in the normal arrangement.

Stifel compensates the syndicate member for the use of the list of OTC trades with a direct payment by check in an amount approximately 36% of the OTC commissions represented on the list. It should be noted that the syndicate member performs no function other than supplying a list of OTC trades.

In order to obtain an appreciation of the degree to which the mutual fund industry has employed this method of brokerage allocation, the staff recently examined the books and records of two conduit firms, Stifel Nicolaus and H. O. Peet. [Footnote: Our information indicates that Boetcher & Co., Rauscher Pierce and Pressman Frolich are also serving as conduit brokers in a manner either identical or similar to that devised by Stifel Nicolaus.] It was discovered that over twenty-five funds have used or are now using this arrangement to reward NASD dealers for sales. In 1966, Stifel Nicolaus alone received over $1,250,000 in give-ups from lead brokers at fund direction. As of September 1967, the firm had already received approximately $1,400,000 under the arrangement. [Footnote: H. O. Peet has participated to a much lesser extent -- receiving only [blank in original] in 1966 and in 1967 to date $162,448.04.]

This amounts to portfolio commissions of approximately 3.5 million dollars (Stifel retained 40%) on dollar volume of $350,000,000. At average prices this equals approximately 9,000,000 shares. A schedule is attached which lists the mutual funds directing give-ups to Stifel for distribution to NASD dealers. The investment advisor and principal underwriter are indicated for each fund along with the gross dollar amount directed for 1966 and 1967 to date.

The real significance of the Stifel arrangement does not stem from the dollar amounts involved, however. Rather its importance lies in the facility with which it enables fund managers to allocate brokerage on portfolio transactions.

<u>AVAILABILITY OF BROKERAGE</u>

The arrangement differs from regional exchange give-up practices in two respects. First, under the Stifel, arrangement the fund's portfolio transactions in listed securities are executed solely in the primary market (NYSE). The fund manager, therefore, need not worry about obtaining best execution, as he must when he trades in listed securities on regional exchanges in order to give-up. Nor is it necessary for the fund manager to cross all blocks on the regional or request lead brokers to send unrelated transactions to the regionals for give-up purposes. Accordingly, as far as the fund manager is concerned, the Stifel arrangement avoids a good deal of the fuss and worry normally attendant to give-Up practices. Secondly, the Stifel device apparently allows the fund managers to give-up to a broader spectrum of recipients and in greater amounts. Even the most liberal regional exchanges permit give-ups only to NASD members and in restricted amounts. Since the conduit broker under the Stifel arrangement is transmitting cash, purportedly from gross proceeds arising out of OTC transactions, to non-members of the NYSE, there is no reason why this income could not be transmitted to the Fund's NASD affiliate with a flow back to the fund or to a non-NASD recipient as well, including the fund itself. [Footnote: The New York Stock Exchange has raised no objection to its members bringing orders to the Pacific Coast Stock Exchange for IDS, though IDS has announced it will return the commission thereby earned to the shareholders of the funds they manage.] Moreover, although the conduit broker is now giving-up on a basis of 50% of the equivalent NYSE commission that would be earned on its OTC transactions, there appears to be no actual impediment to his giving-up a greater amount. Also, presumably the <u>lead broker</u> could give-up directly to NASD recipients in connection with its own over-the-counter trades, thus dispensing with the conduit broker. This would, of course, result in a greater dollar amount of give-up being available for allocation.

Historically, investment company managers and their underwriters, with few exceptions, have not taken advantage of the rules and practices of certain national securities exchanges which permit them to recoup for the benefit of their shareholder a portion of portfolio brokerage. As the Commission observed in its Report on Public Policy Implications of Investment Company Growth:

"It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their advisor-underwriters, all of when are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the fund ... alternatively, the fund itself could form a broker-dealer affiliate to which it could direct give-ups. If this course wore followed -- and no fund now does so -- the give-ups would inure to the direct benefit of the fund's shareholders."

The arrangement devised by Stifel Nicolaus which has been described above gives emphasis to the ease with which fund managers are able to recoup a portion of the fund's brokerage costs and raises anew the question whether, in light of the means available, the fund manager has an obligation as a fiduciary to return this available brokerage to the fund itself. The Division believes that such fiduciary duty exists.

The manager's obligation rests on two rather fundamental bases. First, the commission charged for executing a portfolio transaction is quite obviously an expense of the fund. It seems patently clear that fund managers owe a duty to shareholders to minimize, to the extent possible, the costs incurred in carrying out the business of the fund. Certainly, a manager would be considered to have breached his fiduciary obligation if he were to cause the fund to incur an unnecessary or excessive expense. It is the Division's position that by failing to take advantage of available methods to recoup a portion of the portfolio brokerage charge, the manager is causing the fund to pay an unnecessary amount for securities executions. Stated another way, inasmuch as the commission charge for executing a transaction in securities is an integral part of the net cost of the security or the proceeds received for its sale, a fund manager who fails to minimize the brokerage costs has not exercised the required reasonable diligence in obtaining the best net price. In this regard, a strong analogy can be made to the Delaware Fund case and the principles involved therein.

Secondly, to the extent a portion of the commission charge for portfolio executions is available for give-up, it represents an asset of the fund which the manager has an obligation to conserve for the benefit of the fund shareholders. In cases where the manager not only fails to return this "asset" to the fund shareholders, but directs its allocation for the purpose of securing benefits for the manager and his affiliates, a possible case for conversion may lie. [Footnote: It is a well recognized economic fact that the investment adviser receives a pecuniary benefit from brokerage allocation to retail dealers inasmuch as the device is used to stimulate sales which thereby increase the assets of the fund upon which the investment advisory fee is based.]

The fund managers whom we interviewed defended their position on basically three grounds: (a) they hadn't thought of giving the money back to the shareholders; (b) any reduction in commissions available to selling dealers would cut down mutual fund sales and would increase the possibility of a net redemption status; and (c) it was unfair to subject them to a disciplinary action for activities which ware a common practice throughout the investment company industry. The fund managers noted that the only exceptions were captive funds which were not under the same competitive pressures to curry dealer favor. We pointed out to the adviser who raised (b) above that his argument was of questionable merit since the adviser had more than one fund and was using the give-ups from one fund to pay for sales of .another fund with different shareholders.

It is the staff's view that the failure of fund managers to utilize available distribution channels to return available portfolio brokerage for the benefit of fund shareholders is contrary to the representations appearing in most fund prospectuses that the manager will "seek the most favored prices and execution of orders;" constitutes a breach of the manager's fiduciary obligations; and operates as a fraud and deceit on shareholders. As such, the acts and omissions complained of constitute an act, practice, or course of business which operates to defraud the shareholders of the fund within the meaning of Section 17 (a) of the Securities Act of 1933 ("Securities Act"), Section 10b-5 of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 promulgated thereunder and Section 206 of the Investment Advisors Act of 1940 ("Advisors Act"). [Footnote: More specifically, the staff's allegation of Section 17 (a) is based on the sale of fund shares by means of a false and misleading prospectus while the Section 10b-5 charge relates to fraudulent practices in connection with the purchase and sale of portfolio securities by management in causing the fund to incur unnecessary expenses and in directing the available brokerage for management's benefit.]

It is conceivable that the fund manager's failure to recoup available brokerage and his actions in allocating this brokerage for the purpose of deriving a benefit, may also constitute gross misconduct and a gross abuse of trust within the meaning of Section 36 of the Investment Company Act of 1940 ("Investment Company Act") as well as a fraudulent conversion of fund assets under Section 37 of the Investment Company Act. [Footnote: Cf Brown v. Bullock, 294 F. 2d 415 (2d Cir. 1961), where certain directors of the fund and the management company ware charged with willful conversion under Section 37 for their approval of contracts providing excessive investment advisory and underwriting fees.] However, the staff feels that such allegations would add unnecessary complexity to any complaint which may be filed and, therefore, should not be pursued at this time.

SELECTION OF AN APPROPRIATE RESPONDENT

The staff feels that there are adequate grounds for bringing an enforcement proceeding against a fund manager for his failure to recoup available brokerage. However, the Commission should be aware that there exists significant problems in selecting an appropriate respondent for such proceedings.

In selecting a respondent, consideration must initially be given to the remedy available. For example, all principal underwriters are registered broker-dealers with the Commission. Therefore, where the underwriter also serves as the investment advisor or where there exists an identity of interest between the underwriter and investment advisor, the Commission may bring a broker-dealer proceeding for suspension, revocation or censure, alleging violations of 10b-5 of the Securities Exchange Act of 1934, 17(a) of the Securities Act of 1933, and Section 206 of the Investment Advisors Act of 1940. However, in those cases where the investment advisor and the principal underwriter are different and unaffiliated corporate entities, a broker-dealer proceeding will be unavailable (unless for some unrelated reason the investment advisor is registered under Section 15(b) of the Exchange Act). If the investment advisor is registered with the Commission, a proceeding may, of course, be brought to revoke his registration. In light of the relative sanctions available under these two proceedings, it is clear that the preferred respondent would be a fund manager who serves in the capacity of both investment advisor and principal underwriter.

The second and most obvious problem in bringing an enforcement proceeding against a particular fund manager is a question of relative fairness. With the exception of a limited number of funds which rely on captive sales forces to sell fund shares, all funds use available brokerage on portfolio executions to reward retail sellers and do not recoup this amount for their shareholders. Accordingly, there may be inherent inequity in proceeding against any one or group of fund managers inasmuch as the group, no matter how broad, will not include all parties participating in these arrangements. Moreover, inasmuch as any proceeding against one fund manager will define or determine the fiduciary obligations of all others, there may be a basic unfairness in not allowing these investment advisors to defend their position before the Commission or a court as party respondents.

In addition, it should be pointed out that a successful enforcement proceeding against a fund manager will effectively abolish existing give-up arrangements on an industry-wide basis. Accordingly, any such proceeding will have the effect of rule making in this area. Inasmuch as the Commission has the statutory authority to deal with this problem by adopting an appropriate rule, the funds argue that it would be more appropriate to abolish present give-up arrangements by Commission rule.

CONCLUSION

In the past few years the Commission has received substantial evidence from informal investigations and discussions with industry representatives that the use of give-up and reciprocal practices employed by mutual funds has developed to the point where it threatens wide segments of the securities industry. In recognition of this danger the Division, acting under the direction of the Commission, addressed a letter dated July 18, 1966 to the various self-regulatory bodies which urged the immediate adoption of rule changes and adjustment of the commission rate structure to prevent the continued abuses engendered by these practices.

In late 1966, the Commission released its in depth study on the Public Policy Implications of Investment Company Growth which further confirmed and emphasized the problems attendant to give-up and reciprocal practices. Despite the clear position taken by the Commission in this report and the Division's urging, the exchanges have hesitated in adopting appropriate remedial measures in this area. Indeed, some exchanges have made and are contemplating changes in their rules and practices which could further complicate the task of reaching a satisfactory resolution of this matter. Accordingly, on July 7, 1967, almost a full year after its original request, the Commission directed another letter which urged the exchanges to consider appropriate rule changes on a priority basis and again solicited their view and recommendations on the proper course of regulatory action to deal with this problem.

For the most part the industry's responses indicate that the exchanges either do not agree with the Commission that existing give-up arrangements, require corrective action or that the problem is more appropriately a problem of the mutual fund industry and not an exchange matter. Also, even those self-regulatory bodies which recognize the abuses attendant to give-up practices, feel that appropriate remedial action cannot be taken until more information is available on the nature of the practices employed and the ramifications of their prohibition. Whatever the stated difficulties, it appears that the actual impediment is that the economic pressures exerted on the participants in the securities industry are such as to deter any one of the self-regulatory agencies, acting alone, from taking the initiative in putting an end to these practices. It appears necessary, therefore, for the Commission to take action in order to provide a comprehensive and uniform solution to this problem.

The Division believes that an enforcement proceeding against a fund's advisor-underwriter for failure to recoup available portfolio brokerage provides a vehicle, (by reason of its precedential value) for the Commission to eliminate existing give-up arrangements and assure compliance in all markets. Accordingly, we have drafted for your consideration a proposed order for public proceedings against Tsai Management and Research Corporation, investment advisor-underwriter for Manhattan and Hemisphere Fund. [Footnote: Tsai Management and Research Corporation has been used for the purpose of example.] The Division is prepared to proceed against this fund manager or any group of fund managers as the Commission may determine to be appropriate. However, in light of the complex policy considerations attendant to selecting appropriate respondents, the Division refrains from recommending enforcements proceedings against a designated party.