CHAPTER IV

PORTFOLIO TRANSACTIONS

A. INTRODUCTION

Investment companies buy and sell securities on an extensive scale. In 1965, the securities transactions of just the mutual fund sector of the investment company industry amounted to an estimated $13.6 billion.[1] In all but a small portion of these transactions, the funds utilized the services of brokers and dealers.

Thus brokerage business from the growing investment company industry has become an increasingly important source of revenue to the securities industry. During 1965 this revenue was estimated at more than $100 million for mutual fund portfolio transactions alone.[2] To investment companies and their shareholders, the cost of executing portfolio transactions is a substantial addition to other expenses of operation.[3]

This chapter is concerned primarily with the public policy questions raised by the execution of mutual fund portfolio transactions. Section B describes the securities markets and the extent to which investment companies, particularly mutual funds, use the various markets. Section C deals with the allocation of mutual fund brokerage business. It describes the factors affecting such allocations, the impact of the use of brokerage commissions to pay dealers extra cash for sales of fund shares, the existing controls over this practice and the need for and nature of possible further steps that might be taken by the Commission.

Section D discusses the questions raised by close affiliations between investment companies and broker-dealers who execute their portfolio transactions. Section E discusses the problems raised by investment company practices in connection with the distribution of realized capital gains and presents a recommendation for legislation with respect to such practices. Finally, section F examines problems relating to transactions in the portfolio securities of investment companies by their affiliated persons and presents the Commission's legislative recommendation in this area.

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1 Purchases amounted to about $7.6 billion and sales amounted to about $6.0 billion. Figures do not include transactions in U.S. Government securities. Source: Investment Company Institute.

2 This figure represents the sum of (a) brokerage commissions, and (b) gross profits realized by securities dealers in those transactions in which they, as dealers, bought securities from and sold securities to the funds. Source: Investment Company Institute.

3 Since brokerage commissions are considered a capital item rather than an operating expense under standard accounting principles, they are not reflected in income and expense statements. Nevertheless, they do constitute significant costs to investment company shareholders.

B. THE SECURITIES MARKETS

1. National securities exchanges

(a) The organization of an exchange [4]

Most investment company portfolios consist largely of securities traded on one or more national securities exchanges.[5] The exchanges are voluntary associations which maintain organized marketplaces for securities.[6] Fourteen exchanges have registered with the Commission as "national securities exchanges" and under the Securities Exchange Act of 1934 ("Exchange Act") are required to assume self-regulatory responsibilities over the activities of their members.[7]

Trading on an exchange is—and by law must be—confined to (1) securities that have been "listed" with the exchange and "registered" with the Commission for such trading, and (2) securities as to which unlisted trading privileges have been granted? The listing of a security is initiated by the issuer who must apply for such listing to the exchange [9] and must enter into a listing agreement with the exchange by which it undertakes to comply with the exchange's regulations.[10] Unlisted trading privileges with respect to a security, on the other hand, are granted by the Commission at the instance of an exchange upon a showing that the extension of such privileges "is necessary or appropriate in the public interest or for the protection of investors." [11] A security as to which unlisted trading privileges are in effect is usually one that is listed on another exchange."

(b) Minimum commission rate schedules

Direct access to exchange trading floors is limited to exchange members. Since each exchange has a limited number of memberships, one who wishes to join an exchange must purchase a membership—commonly referred to as a "seat"—usually from an existing member. Exchange members may execute orders personally on the exchange floor or have them handled by other members at rates less than those charged nonmembers.[13]

The brokerage commissions which exchange members charge nonmembers for executing transactions on an exchange are governed by minimum commission rate schedules. These schedules which have been adopted by all national securities exchanges are substantially similar and are based on the dollar value of a single round-lot transaction, which for all but a few inactively traded stocks is a hundred shares. The commission rates vary with the price per share of the security, but the commissions charged on an order for 10,000 shares of

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[4] For detailed treatment, see Special Study, pt. 2, 35–48, 294–346. For a brief historical and comparative account, see 14 Encyclopedia of the Social Sciences 397–402 (1937).

[5] See Wharton Report 182–210.

[6] Section 3(a) (1) of the Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market-place or facilities for hringing together purchasers and sellers of securities . . . .

[7] Exchange Act sec. 6.

[8] Exchange Act' sec. 12.

[9] Exchange Act: sec. 12(b).

[10] See e.g., New York Stock Exchange Manual A–18, et seq., CCH American Stock Exchange Guide par. 10,001, et seq See also Special Study, pt. 2, 11: "As a direct result of the listing concept most issuer; of securities traded on an exchange are brought into a contractual relation with the exchange itself, and the latter is in a position to impose a degree of regulation directly on such issuers."

[11] Exchange Act, sec 12(f)(2).

[12] Unlisted trading privileges for securities not listed for trading on any exchange are limited?? securities admitted to such trading prior to August 20, 1964. Exchange Act, sec. 12(f)(1). Such securities are still traded only on the American Stock Exchange.

[13] The rules of certain of the exchanges—hut not the New York Stock Exchange—permit their members to charge nonmember broker-dealers rates somewhat lower than those provided for in minimum commission rate schedules and to share or "give up" to such broker-dealers specified portions of the commission charged public investors for the execution of transactions on these exchanges. See pp. 170–172, infra.

a given security (100 round lots) will be exactly 100 times the commission for a 100-share order. The Securities and Exchange Commission has the authority to alter or supplement exchange commission rate schedules under circumstances and procedures specified in the Exchange Act.[14]

Although exchange rules permit their members to charge higher commissions than those provided for in the minimum commission rate schedules, the minimum has, in practice, become a ceiling as well as a floor. Hence, though exchange members compete vigorously among themselves, with members of other exchanges and with non-member broker-dealers for investor patronage in exchange-traded securities they may not do so on the basis of direct price competition.

(c) The New York Stock Exchange

During 1965, the New York Stock Exchange ("NYSE"), which is by far the most significant of the national securities exchanges, accounted for about 82 percent of the aggregate dollar volume of all stocks traded on the 14 registered national securities exchanges.[15] The portfolios of most mutual funds tend to be heavily concentrated in securities listed on the NYSE and most of their transactions are executed on that exchange. At the end of 1965, approximately 81 percent of the funds' stock holdings consisted of NYSE listed preferred and common stocks.[16]

(d) The American Stock Exchange

During 1965 trading in stocks on the American Stock Exchange ("Amex"), the second largest national securities exchange, accounted for about 9.6 percent of the aggregate dollar volume of all such trading on national securities exchanges[17] and exceeded the dollar volume of stock trading on all other exchanges except the NYSE.[18] However, while securities listed on the New York Stock Exchange are traded on regional exchanges, they are not traded on the Amex. Since mutual fund portfolios tend to be heavily concentrated in NYSE-listed stocks, mutual fund trading on the Amex does not account for a significant portion of fund portfolio transactions.

(e) The regional exchanges

There are 11 registered securities exchanges in cities other than New York.[19] On three of these exchanges trading is almost entirely confined to mining stocks that sell for less than $1 a share, while trading on a fourth exchange is confined to commodities.[20] Unless the text indicates otherwise "regional exchanges" will refer to the seven other exchanges. They are the (1) Midwest Stock Exchange; (2) Pacific Coast Stock Exchange; (3) Philadelphia-Baltimore-Washington Stock Exchange; (4) Boston Stock Exchange; (5) Detroit Stock Exchange; (6) Cincinnati Stock Exchange and (7) Pittsburgh Stock Exchange.

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[14] Exchange Act, sec. 19(b)(9).

[15] The dollar volume of NYSE stock trading in 1965 was approximately $73.2 billion while the dollar volume of stocks traded on all registered exchanges amounted to approximately $89.2 billion.

[16] Source: Investment Company Institute.

[17] Excluding the NYSE and Amex, the other national securities exchanges accounted for 8.3 percent of the dollar volume of stock traded on national securities exchanges in 1965.

[18] Stock transactions on the Amex during that year involved about $8.6 billion. Total Amex volume in all securities was approximately $9 billion.

[19] In addition to the NYSE and the Amex, there is a third exchange in New York City, the National Stock Exchange. Its trading volume is not substantial.

[20] In addition, there are three other regional exchanges that have been exempted from registration by the Commission pursuant to sec. 5 of the Exchange Act because of their limited volume.

The securities traded on these regional exchanges are of two quite different types. The first type consists of securities for which there is no exchange market other than a regional exchange. Investor interest in these "solely traded" securities is usually of a predominantly local character and their trading volume is relatively small.[21] The securities themselves usually do not meet the listing standards of the NYSE.

The second type consists of securities listed on the NYSE or on the Amex and also traded on the regional exchanges. These "dually traded" securities, which accounted for approximately 98 percent of the dollar volume of the regional exchanges during 1965, consist in the main of the most active stocks on the NYSE. Many NYSE stocks are traded on at least one regional exchange, and some of the most active NYSE stocks are traded on all of the regional exchanges. The Special Study also noted the tendency for volume in dually traded stocks to be heaviest in the securities of companies closely connected with the region in which the exchange is located.[22] Almost all investment company transactions on regional exchanges involve dually traded securities.

2. The over-the-counter markets in unlisted securities

Although exchange listed securities account for the bulk of the dollar volume of equity securities traded in the United States, the securities of most publicly held companies are not traded on an exchange [23] but in what is commonly called the "Over-the-counter" market.[24] The securities traded in this market consist of almost all bank and insurance stocks, corporate and government bonds (including municipals), some substantial utility issues, and the stocks of a number of sizable industrial corporations. Most investment companies hold some over-the-counter securities and a few invest principally or exclusively in such securities.[25]

The over-the-counter market has no central trading point at which brokers for buyers and sellers or dealers can come together. Instead, they communicate.with each other by telephone and teletype and by private quotation services. The focal points of the over-the-counter market are those firms that make markets in particular securities. They maintain inventories of unlisted securities and are engaged in buying such securities from and in selling them to other broker-dealers.[26] Profits from the marketmaking function in over-the-counter securities are derived primarily from the spread between the prices at which dealers contemporaneously buy and sell. Over-the-counter marketmakers compete among themselves on a price basis. To make reasonable efforts to obtain the best price in over-the-counter transactions, brokerdealers with customer orders for securities in which they are not making markets check prices with several competing marketmakers.

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[21] See Special Study, pt. 2,913-914.
[22] See Special Study, pt. 2, 931.
[23] There are over 2,900 stock issues listed on all the registered exchanges. On the other hand, there is some Over-the-countertrading—often only sporadic—in the stocks of about 30,000 corporations.
[24] For a comprehensivesurvey of the over-the-countermarket, see Special Study, pt. 2, 533–796.
[25] In this category are investment companies whose portfolios consist largely or wholly of bank and/or insurance stocks. Among those companies are Insurance Securities Trust Fund (approximate June 30, 1966, assets $1.1 billion), Century Shares Trust (approximate June 30, 1966, assets $101 million), Capital Shares Inc. (approximate June 30, 1966, assets $89 million), and Life Insurance Investors, Inc. (approximate June 36, 1966, assets $93 million).
[26] Some of these firms do not deal with the general public. Others, the "integrated" firms, maintain large retail departments. See Special Study, pt. 2,555, which notes that "The differencebetween the two kinds of wholesale dealers is not a sharp one in all cases and may be a matter of degree. For example, a pure wholesale dealer may have some retail customers, and an integrated firm may also have a trading department which trades some stocks without regard to the firm's retail activities."

Members of the investing public sometimes trade over-the-counter securities directly with marketmakers in these securities. More often, however, they trade through their own broker-dealers who seek out the marketmakers and charge commissions or markups for their services. Large institutional investors, such as investment companies, on the other hand, are frequently sought out by, and are in a position to deal directly with marketmakers to whom they are important and knowledgeable customers. Since in such cases they pay no fee or service charge to a broker-dealer intermediary, they usually are able to consummate over-the-counter transactions at costs lower than those incurred by other types of public investors.[27]

3. *The third market*

Many securities traded on exchanges can be bought or sold by nonmembers of such exchanges in a specialized segment of the over-the-counter market—the so-called "third market." [28] The third market has developed for two main reasons. First, it enables professionals in the securities business who are not members of an exchange to do a remunerative business in listed securities. A broker-dealer who does not belong to an exchange must use an exchange member if he wishes to have an order executed on the exchange. The rules of the NYSE, the Amex, and the Midwest Stock Exchange in effect require that their members charge nonmember professionals the same minimum commission rates as the general public.[29] By executing transactions in listed securities in the third market, nonmember professionals can profit from such transactions, although charging their customers no more and sometimes less than if the transactions were executed through the facilities of the exchanges.[30]

Another reason for the development of the third market is the ability of large investors sometimes to do business more economically there than on the exchanges. Institutions may deal directly with a marketmaker who, acting as principal, buys or sells for his own account at a net price which may include a markup but does not include a service charge or commission. In other cases, where an institution's order is of such size that the marketmaker does not wish to effect the transaction for his own account, the marketmaker may seek out the opposite side of the order and effect a cross in his office.[31] As a nonmember of an exchange, the marketmaker is not bound by a minimum commission rate schedule which on such a transaction requires the charging of two minimum commissions. Accordingly,

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[27] Institutional investors frequently are able to obtain better terms from marketmakers than retail dealers are able to obtain. See Special Study, pt. 2,627.

[28] See generally, Special Study, pt. 2, 870-906.

[29] A number of regional exchanges permit their members to charge professionals commissions somewhat lower than the minimum rates charged the general public.

Although the NYSE does not permit nonmember professionals such preferred rates, under a recent amendment to NYSE rule 394, members holding a customer's round-lot order may solicit a qualified nonmember marketmaker to participate in the execution of the order for the nonmember's own account and execute the order off the floor of the exchange, if after checking on the exchange they find that they can get a better execution for their customer by dealing with the nonmember. NYSE rule 394(b).

[30] The Special Study concluded that "this motivation apparently explains the great bulk of the trading by broker-dealer intermediaries on the third market. These broker-dealers are distributed in communities ranging from small to large throughout the country and, while including some sizable firms, generally consist of the smaller ones." Special Study, pt. 2, 884. See also id. at 905: "Off-board trading of listed stocks * * * operates to permit nonmember broker-dealers to offer their public customers a more complete line of securities than would be possible in the absence of such a merket. It encourages a sharper competition among broker-dealers whioh should redound to the benefit of their public customers."

The Special Study also noted that similar motives account for the fairly extensive participation of commercial banks in the third market. Banks that act as agents for their customers in securities transactions sometimes find that they are able to obtain more compensation for their services—without imposing any greater charge on their customers or even by charging their customers less—by handling a transaction on the third market rather than on an exchange. Special Study, pt. 2, 884-885.

[31] Cf. pp. 171-172, infra.

he can, and almost invariably does, charge a commission or services charge in connection with large crosses which is well below the minimum exchange commission. Although prices in the third market are closely tied to those on the principal exchanges, buyers benefit from using the third market so long as the total cost of acquiring the securities they seek is below the sum of (1) the price they would have had to pay on the exchange and (2) the fixed commission that would necessarily have been paid had the exchange been used.[32]

The cost difference can be significant. For example, the exchanges" commission schedules provide for a commission of one-tenth of 1 percent plus $39 for each round-lot transaction involving $5,000 or more. Thus, a $5,000 order for 100 shares (one round lot) of a $50 stock results in a commission of $44. A $50,000 order for 1,000 shares (10 round lots) of the same stock costs $440 in commissions and a $500,000 order for 10,000 shares (100 round lots) of that stock costs. $4,400 in commissions. The buyer and the seller must each pay these amounts as commissions. Thud market firms are often willing, indeed eager, to handle a large order for compensation much below the commissions that exchange members have to charge.

The focal points of the third market are the marketniakers. The. Special Study noted:

> [T]he marketmakers trade almost exclusivelv with institutions and with broker-dealers. Since institutions trade largely through skilled trading departments, the market is almost exclusively a professional one * * *
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> [I]n keeping with the professional character of their customers is * * * the omission of the various customer services performed by the public commission houses on the exchanges. * * * The market makers appear to have no security research or investment counsel staff, sales representatives, customers' rooms or similar personnel and facilities devoted to the merchandising of listed securities. Nor do they engage in margin financing, safekeeping of securities or many of the auxiliary service functions usually provided by stock exchange firms for customers. These market makers thus tend to correspond to the purely wholesale firms in the over-the-counter market generally, although the bulk of their dollar volume is 'retail' business with institutions which are the public customers, as distinguished from 'wholesale' business with other brokerdealers or banks representing public customers.[33]

Institutional traders often use the third market as well as the exchanges to acquire or dispose of large blocks of securities. However, the Special Study pointed out that mutual fpnds make appreciably less use of the third market than other institutional investors. It found that:

> Pension funds did a high portion of their trading in NYSE stocks on the third market—18.7 percent in March 1961 and 15.7 percent in April 1962. Insurance companies, both life and nonlife, and common trust funds also tended to

[32] [illegible], the third market is advantageous to the seller so long as it brings him a price that is greater t[illegible] an [illegible] p[illegible] that would have been received on the exchange minus the commission that would have been paid [illegible] exchange fa[illegible]iliti[illegible] b[illegible]
[33] Specia[l] Study, [illegible], 88[illegible]

> be relatively heavy users of the third market. But open-end investment companies (load) effected only 6.0 percent of their NYSE business on the third market in March 1961 and 6.1 percent in April 1962. * * *[34]

4. *The fourth market*

Sometimes buyers and sellers deal directly with each other — without the aid of professional intermediaries. Such trading by institutional investors has been popularly labeled the "fourth market." Recently, there have been reports of some growth in the importance of this type of trading.[35] Investment companies use the fourth market on occasion.[36] Some of these transactions are sizable. At present, however, the fourth-market activity of investment companies appears insignificant in relation to the total volume of their portfolio transactions.

5. *Underwritten offerings*

Investment companies also purchase and sell securities through underwritten offerings of securities. An underwritten offering may be made on behalf of the issuer of the security, its controlling person or a large shareholder such as an institutional investor.[37] Such offerings normally involve the sale of blocks of securities that are too large in relation to trading volume to be sold through normal market channels.

The sale of a large block of securities under these circumstances requires special selling efforts by broker-dealers. To obtain such efforts the seller usually engages the services of one or more underwriters who often organize selling groups of dealers to assist in the public distribution. The professional participants in an underwritten offering derive their compensation from the "spread" between the amount they pay the seller and the price they receive from the buyers.[38] The spread is usually several times more than an exchange commission and furnishes the incentive for the selling effort required in the distribution.

Underwritten securities generally are sold to the public at fixed prices. When investment companies purchase securities in an underwritten offering, they must pay the same price as other purchasers. Purchases of securities by investment companies through underwritten offerings vary considerably from year to pear and from company to company. This variation reflects the fluctuating volume of such offerings in the securities markets generallv and the differing degrees of interest in these offerings demonstrated by the various fund managers.

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[34] Special Study, pt. 2, 881.

[35] For further discussion see Robbins "The Securities Markets," 257–261 (1966).

[36] The Commission on Skptember 8, 1666, adopted rule 17a–7 under the Act which exempts from sec. 17(a) purchases or sales, between affiliated registered investment companies for no consideration other than cash payment against prompt delivery, of a security traded on a national securities exchange, if the principal market for such security is a national securities exchange and the transaction is effected at the independent current market price of such security on such principal market and no brokerage commission, fee or other remuneration is paid in connection with the transaction and the transaction is consistent with the policy of such registered investment companies. Investment Company Act Release No. 4697.

[37] Sales by issuers are called "primary distributions," and sales by other persons of outstanding and issued securities are called "secondary distributions." Public distributions of securities by issuers, their controlling persons and their underwriters are. generally subject to registration under the Securities Act. Although such distributions by institutional investors are subject to registration if the institution is deemed a Controlling person of an issuer or an underwriter, institutions often do not occupy that status in relation to the securities they hold. See generally, ch. II, pp. 59–61, supra.

[38] In another type of underwriting, the "best-efforts" underwriting, underwriters are selling agents rather than risk bearers. See 1 Loss, Securities Regulation 171–172 (2d ed., 1961). Their compensation takes the form of a commission deducted from the selling price.

Mutual fund sales of portfolio securities through underwriters generally have been increasing. With the growth of the mutual fund industry, many of the larger funds and fund complexes have tended to rely more heavily on such offerings to sell sizable holdings that otherwise cannot be quickly liquidated through normal market channels at prevailing market prices.[39]

When these funds sell portfolio securities in an underwritten offering, they, like all other sellers, pay the underwriting spread. This amounts to considerablv more than the sales charges they incur when selling portfolio securities through ordinarv market channels. The NYSE has developed a number of special plans to facilitate distributions of substantial blocks of securities on the exchange.[40] Exchange members may also participate in distributions of NYSE listed securities off the exchange with the prior approval of the exchange.[41]

6. *Private placements*

It is often possible for issuers and their controlling persons to raise substantial amounts of capital through "private or direct placements" of securities with a single large investor or a small group of such investors. If such investors purchase for "bona fide" investment purposes, i.e., with no intention to distribute publicly, the transaction is exempt from the registration requirements of the Securities Act.[42] Such private placements are normally negotiated with the aid of professional intermediaries who bring the parties together and who receive fees for their services. As in an underwriting, the intermediary's fee in a private placement usually comes entirely from the seller.

Institutional investors, including investment companies, constitute the most important market for private placements. However, since such investors undertake to purchase for investment, tbey are restricted in their ability to resell to the public without complying with the registration requirements of the Securities Act. Although a number of the larger mutual funds make active efforts to search out attractive private placements, they do not figure as prominently in the private placement market as do institutional investors such as insurance companies, pension funds, university and similar endowment funds.

C. FACTORS AFFECTING ALLOCATION OF MUTUAL FUND BROKERAGE COMMISSIONS

1. *The creation of disposable brokerage*

Brokerage commissions generated by investment companies and other large institutional investors are a particularly important and potentially profitable source of revenue to member firms of national securities exchanges. In the securities industry salesmen usually receive from 25 to 40 percent of the commissions charged to public customers. Mutual funds, like other institutional investors of sub-

[39] See ch. VII, p. 286, infra.

[40] See Special Study, pt. 1, 560-563; pt. 2, 842-844.

[41] Subject to certain exceptions the rules of the NYSE generally prohibit its member firms from trading listed stocks in a market other than the NYSE itself or one of the regional exchanges on which the particular issue is traded (NYSE rules 394 (a) and (b)). However, the NYSE will permit members to engage in concentrated efforts to dispose of listed securities "off board" where such efforts are required for successful distribution. See Special Study, ut. 1, 563-564; pt. 2, 843-844.

[42] Sec. 4(2) of the Securities Act exempts from the registration requirements "transactions by an issuer not involving any public offering."

stantial size, however, are usually "house" accounts on which salesmen often do not receive commissions.

Moreover, institutional brokerage accounts produce numerous transactions which on the average are considerably larger than those of other types of investors. Although a large order may make greater demands on a broker than a small one, member brokers can profitably execute and clear transactions for investment companies and other large institutional customers at a cost which is only a fraction of the commissions they must charge. Thus, large institutional investors have substantial amounts of brokerage commissions at their disposal. As the Wharton Report noted:

> [F]or the larger institutional investors, including mutual funds, it is understood that a smaller or larger fraction of brokerage commissions, depending on transaction size, problems, and associated services, is more or less at the disposal of the investor.[43]

2. *The use of disposable brokerage commissions*

The allocation of portfolio brokerage is an increasingly important aspect of the relationships between financial institutions and the brokerage community. Banks and insurance companies commonly allocate the brokerage business which they control to brokers who provide them with business. For the mutual fund industry such allocations take on special significance.

The managers of some mutual funds are owners of brokerage firms which are members of national securities exchanges. A substantial portion of the portfolio brokerage of these funds is usually allocated on the basis of the close affiliation between the brokers and the funds. In a very few such instances the brokerage commissions paid to affiliated brokers serve to reduce the funds' advisory fees or costs. In most instances they increase the profits of the affiliate and therefore add to the compensation that the fund managers obtain by virtue of their relationships to the funds.[44]

However, much of the brokerage commissions generated by the mutual fund industry is allocated to broker-dealers who are not affiliated with fund managers. They obtain these commissions in return for services they provide to the funds, their managers, and underwriters—services for the most part related not to the brokerage function involved in the execution of portfolio transactions but to the sale of new fund shares. The factors influencing the allocation of mutual fund brokerage and the techniques utilized to distribute these commissions within the large and diverse brokerdealer community have resulted in an intricate pattern of business relationships between mutual fund managers and the securities community. An understanding of these factors and techniques is important to an evaluation of the regulatory problems posed by allocations of mutual fund portfolio brokerage.

(*a*) *Supplementary investment advice*

The commissions prescribed by the exchanges pay for more than the execution and clearance of transactions. Those commissions also compensate exchange members for soliciting brokerage business and

43 Wharton Report 539.
44 See ch. III, pp. 108–110, supra.; and pp. 172–173, infra.

for services ancillary to the brokerage function. Those ancillary services include furnishing investment research and recommendations to public investors. Indeed, the advisory and other services that brokerage firms customarily provide without separate charge constitute a part of the competition for investor patronage.[45]

Investment advice and research also are used to attract orders from institutional investors. Some brokerage houses prepare special reports with respect to market trends, specific industries, and particular stocks, which are considerably more detailed than those which they make available to their smaller individual customers. These reports often are sent to institutional investors in the hope of receiving their brokerage business. Investment companies and other large institutional investors are also in a position to request specific analyses from the research staffs of brokerage houses. They do so selectively, seeking to benefit from the expertise in particular areas of certain brokerage houses and of certain of their well-regarded analysts. Brokers who furnish such studies receive commission business in return.

The extent to which fund managers use brokerage house research varies considerably from company to company and from complex to complex. It depends upon the size of the company or complex, the depth and quality of the investment advisory staff that serves it, the specific analytical techniques favored by the adviser, and the adviser's individual judgment as to the value of brokerage house research. In general, the larger investment companies and complexes with advisers which have extensive research staffs of their own have been less dependent on these services than the smaller companies. But almost every investment company adviser makes some use of brokerage house research and uses brokerage commissions to pay for such research, including those who are closely affiliated with exchange member firms which execute most of the company's portfolio transactions.

(6) Other services

Most investment companies and other large institutional investors also utilize brokerage commissions to obtain other types of services from broker-dealers. These often include private wire and teletype services, which enable managers to obtain current market information speedily and economically. Mutual funds also require pricing of their securities portfolios to compute the net asset value of their shares in connection with sales and redemptions. Brokerage houses usually provide this service in return for brokerage commissions. A few investment companies also utilize brokerage commissions to obtain custodial services from broker-dealers.[46] Others use brokerage to reward broker-dealers for bringing private placement investment opportunities to their attention.

(c) Sales of fund shares

Both the Wharton Report and the Special Study pointed out that a substantial portion of mutual fund brokerage commissions is used to reward dealers for sales of fund shares.[47] Such utilization of brokerage commissions provides fund dealers with sales compensation in

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45 The depth of the research on which broker-dealer investment advice is based varies considerably from firm to firm. See Special Study, pt. 1, 344–358.

46 In most cases, however, mutual funds use banks as custodians and pay cash compensation for these services. See ch. III, pp. 91–92, supra.

47 Wharton Report 33; Special Study, pt. 4, 233.

addition to that furnished by the sales load and increases their incentive to sell fund shares. A mutual fund underwriter characterized as "universal" the practice of allocating fund brokerage to reward dealers for sales.[48] The Wharton Report noted with respect to its study of factors affecting the allocation of mutual fund brokerage:

> Sales of investment company shares were not only most frequently referred to as a factor influencing brokerage allocations, they were commonly referred to in these replies as the principal factor influencing these allocations.[49]

Of course, a desire to reward sellers of fund shares does not materially influence the brokerage allocation policies of those mutual funds whose shares are sold exclusively by their underwriters' own retail selling organizations. However, among the bulk of the funds whose shares are distributed wholly or largely through independent retail dealers, the use of brokerage commissions as extra sales compensation has emerged as a significant factor in the competition for dealer favor. Most of the larger dealer-distributed funds use substantial portions of their brokerage in this way. The few that do not are closely affiliated with broker-dealers who handle the funds' portfolio business.[50] Brokerage commissions are also used by no-load funds to reward broker-dealers for recommending the fund to their customers.

The amount of brokerage commissions available to fund underwriters for use as compensation for sales depends on a number of factors. These include the amount of sales of fund shares, the size of the fund or fund complex, portfolio turnover rates, use of nonexchange members for the execution of portfolio transactions, and the amount of brokerage commissions allocated for nonsales services. The relationship of the amount of brokerage commissions to the amount of sales of fund shares ("reciprocity ratio") varies considerably from fund to fund.[51] Moreover, the same fund's reciprocity ratio may vary from dealer-to dealer depending upon how easy or difficult it is to give brokerage business to a particular dealer. A dealer who sells a large volume of a fund's shares and is also an NYSE member may enjoy a reciprocity ratio as high as 5 percent from a fund that gives a much lower ratio to most of its dealers.[52] If a reciprocity ratio of 5 percent were added to a dealer discount of 6.5 percent, dealers would enjoy compensation of 11.5 percent of the amount of their fund share sales.

Generally, the larger funds and fund complexes are able to use a much greater percentage of their brokerage for sales than do the smaller ones. The brokerage allocations (not including principal transactions) for sales and other services of the 20 largest dealer-distributed funds, which were not closely affiliated with exchange members, are listed in table IV-1, below. These funds paid, for their fiscal years ended during the period from July 1, 1965 to June 30, 1966, $42 million in

[48] Special Study, pt. 4, 215–216.
[49] Wharton Report 527.
[50] Some underwriters of these broker-dealer affiliated funds, however, give their dealers a larger portion of the sales load than have other dealerdistributed funds. For example, Dreyfus Fund, Inc.'s principal underwriter and adviser, Dreyfus Corp., which was until 1965 wholly-owned by Dreyfns & *Co.*, an NYSE member, does not allocate fund brokerage as compensation for sales, but allows its dealers to retain 7.875 percent of the 8.375 percent sales load. In 1966 the median dealer concession among dealer-distributed funds was 6.5 percent.
[51] A dealer would receive a 1-percent reciprocity ratio if he executed portfolio transactions equal to the amount of his mutual fund share sales or received give-ups equal to the commissions which would be received on portfolio transactions of that amount.
[52] The Special Study found a 1 percent ratio in existence, but indicated that 2 percent was also used (Special Study, pt. 4, 217–218).

portfolio brokerage commissions, about 40 percent of the estimated total portfolio brokerage commissions paid by all members of the Investment Company Institute during 1965. They allocated about 53 percent of their combined brokerage commissions to compensate dealers who sold their shares. The extent of these allocations varied widely among the 20 funds—from 19 percent in the case of Axe Houghton Fund B, Inc., to 90 percent for Boston Fund, Inc. The median percentage was 61 percent.[53] These large funds devoted only about 13 percent of their total portfolio brokerage commissions—about $5.6 million—to pay for supplementary advisory, pricing, wire, and other services. The balance of their brokerage commissions was reported as allocated on the basis of the brokers' ability to execute the transactions.

TABLE *IV-1.—Allocation of brokerage commissions for sales and other services by 20 of the largest mutual funds [a] for their fiscal years ended July 1, 1965–June 30, 1966*

Name of fund	June 30, 1965, net assets (millions)	Total commissions (thousands)	Allocated for sales [b]		Allocated for other services [b]	
			Amount (thousands)	Percent	Amount (thousands)	Percent
1. Massachusetts Investors Trust	$2,102.6	[c] 52,797	$1,878	67	$331	12
2. Wellington Fund, Inc	1,934.5	5,488	3,117	57	461	8
3. Affiliated Fund, Inc	1,134.1	2,246	966	43	180	8
4. Fundamental Investors, Inc	940.6	3,355	2,885	86	369	11
5. Massachusetts Investors Growth Stock Fund, Inc	738.9	[c] 1,840	1,126	61	125	7
6. National Securities Series	637.9	1,946	1,498	77	156	8
7. Fidelity Fund, Inc	536.4	5,243	1,363	26	262	5
8. Investment Company of America	404.6	2,707	1,435	53	135	5
9. Television Electronics Fund, Inc	388.7	1,409	873	62	535	38
10. Boston Fund, Inc	363.1	471	424	90	9	2
11. Dividend Shares, Inc	361.9	384	334	87	50	13
12. Chemical Fund, Inc	360.5	340	272	80	41	12
13. The George Putnam Fund of Boston	360.5	1,043	678	65	365	35
14. Puritan Fund, Inc	347.0	1,417	425	30	298	21
15. Fidelity Trend Fund, Inc	301.0	5,827	1,748	30	641	11
16. American Mutual Fund, Inc	285.1	1,278	741	58	64	5
17. The Putnam Growth Fund	283.3	1,701	936	55	765	45
18. Group Securities, Inc	270.6	716	587	82	129	18
19. Putnam Investors Fund, Inc	251.8	1,168	701	60	467	40
20. Axe-Houghton Fund B, Inc	228.2	642	122	19	199	31
Total	12,231.3	42,018	22,109		5,582	
Weighted mean				53		13
Median				61		12

[a] Includes the largest funds as of June 30, 1965, except those that are closely affiliated with a broker-dealer' those that are sold predominantly by underwriters who maintain their own sales forces and one that does not continually offer its shares.

[b] In certain instances only the percent allocated or the dollars allocated were available. In these cases the other figure has been calculated.

[c] Estimated to include 21 percent of MIT's, and 32 percent of MIGS', dollar volume of portfolio business for which there was no allocation for sales or other services.

In contrast to the large funds, sales of fund shares are not a significant factor in the allocation of brokerage for the smallest of the dealer-distributed funds. The annual reports and current prospectuses of the dealer-distributed funds with assets between $1 million and $25 million, which are not closely affiliated with exchange members, show that in 1965 these funds allocated almost all of their brokerage

[53] Table IV-1 does not include the large dealer distributed funds which are closely affiliated with exchange members. At least two of these funds—Broad Street Investing Corp. and National Investors Corp., both closely affiliated with the NYSE firm, J. & W. Seligman & Co., devoted significant portions of their total brokerage commissions to rewarding broker dealers for selling their shares—17 percent for Broad Street Investing Corp. and 33 percent for National Investors Corp. Such use of brokerage commissions by broker affiliated funds indicates the importance their management places on the sale of fund shares, since these commissions could have been translated directly into brokerage income for the affiliated broker.

business for services other than sales. Most of these funds did not use any of their brokerage to reward dealers who sold their shares. The few funds in this class that did allocate some brokerage to sales were generally unable to devote substantial portions to this end. Thus, underwriters for these small funds usually cannot provide dealers as much extra cash incentive to sell their shares as can underwriters for the larger funds.

3. Allocation techniques

(a) Reciprocity

The simplest way to use brokerage to pay brokers for nonbrokerage services, including sales of fund shares, is to place orders with the brokers whom one wishes to reward. Thus, if the fund's managers wish to pay a particular brokerage firm a thousand dollars, they simply place orders with that broker sufficient to produce commissions of that amount. The apportionment of brokerage orders on this basis is known as "reciprocity." Accordingly, such orders are commonly referred to as "reciprocal business" or simply "reciprocals."

Although simple reciprocity of this sort is used in the mutual fund industry to give additional cash compensation to a limited number of broker-dealers who sell fund shares, the shares of the large broker-dealer distributed funds are sold by hundreds — ometimes thousands — of independent retailers.[54] Many of the retailers to whom the funds feel obligated to give brokerage business do not belong to an exchange. It is practically impossible to place significant quantities of fund brokerage with these over-the-counter retailers, since they cannot execute orders on the exchanges and since the NYSE and some other exchanges do not permit them to share the commissions on orders placed with an exchange member. Nor are these retailers in a position to serve the funds in the over-the-counter market.[55]

Similar considerations severely limit the ability of fund managers to give over-the-counter business to the over-the-counter dealers that sell fund shares.[56] Although underwritten offerings provide a means of giving reciprocal business to over-the-counter dealers,[57] funds seldom buy them in sufficient quantity to make this sort of reciprocity a source of income to a significant number of such dealers.

Moreover, even within the NYSE community itself simple reciprocity can be an impractical way of spreading the funds' portfolio brokerage business as widely as the fund managers wish. Well over 300 NYSE member firms sell fund shares. Most fund managers believe that placing orders with *so* many brokers would impose an undue burden on their trading departments and would be inconsistent with good portfolio management.

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[54] For a description of the 2,500 independent broker-dealer distribution network of one fund complex, see Special Study, pt. 4, 105–106.

[55] Many of these dealers are essentially retailers of mutual fund shares who do very little or no general securities business (*See* Special Study, pt. 1, 17: id., pt. 4, 106, 256.) They constitute a specialized segment of the retail securities business with characteristics that differentiate it from the business generally. *See* e.g., Rule 15c3–1(a)(2) under the Exchange Act, 17 C.F.R. 240.15c3–(a)(2) (Supp. 1966), which permits dealers in mutual fund shares who do not do a general securities business and who meet certain specified conditions to do business with a minimum net capital of as little as $2,500 although brokers and dealers generally are required "to have and maintain net capital of not less than $5 OM)".

The typical nonexchange member who sells mutual funds does not made markets in seeurities. If he were to receive an over-tho-counter order from a fund, he would have to take it to a marketmaker. The fund could have gone to that marketmaker in the first instance and received a price as good as or better than the retail dealer would have obtained. Moreover, if a retailer were used, the fund would have to pay him for his services. *See* pp. 158–161, supra.

[56] See Special Study, pt. 2,627, n. 238.

[57] When funds purchase securities in this manner their managers sometimes direct compensation to particular broker dealers hy having them included as members of the selling group.

As one fund officer explained:

> We prefer that discussions of orders for the funds be done with a limited number of brokers in order to insure that the funds are regarded as principal clients of these brokerage firms—which aids in the getting of the best execution. These brokers we call primary brokers.[58]

Orders of the size that the funds customarily place call for a high degree of brokerage expertise. There are differences in brokerage skill and efficiency among NYSE member firms. Indeed, many such firms have no floor brokers or clearance facilities of their own and do not execute their customers' orders themselves.[59] Instead, they transmit their customers' orders to other NYSE firms who have such facilities and handle the business generated by nonfloor members in return for a share of the commissions.[60]

Another factor accounting for the funds' reluctance to place brokerage orders with a large number of the NYSE members that sell their shares is the belief that such a dispersion of their brokerage business—even among brokers of equal skill—would impede them from obtaining the best possible price for the securities they buy and sell. Some fund managers and brokers do not consider it feasible to shift from broker to broker while a program of accumulating or disposing of a given security is in progress. It is claimed that such shifting takes an order away from the broker just when he is getting "the feel of the market." On the other hand, others maintain that dividing a gradual program of accumulation among a limited number of brokers in whom they have confidence enables a fund "better to cover its tracks."

Because of these considerations, most funds seek to concentrate their brokerage business among a relatively small number of "primary brokers" believed to be especially capable of providing good executions. Yet, at the same time, they seek to distribute the income generated from that business to a much larger number of broker-dealers. This objective cannot be attained without the aid of techniques considerably more complex than simple reciprocity.

There are some techniques which permit non-NYSE firms to benefit to some extent from reciprocal business placed with NYSE firms. Broker-dealers who are not members of the NYSE can ask the funds whose shares they sell[61] to place reciprocal business with a particular NYSE firm, "courtesy" of the nonmember. This is beneficial to the nonmember in several situations. For example the members can "reciprocate" for fund business by giving over-the-counter business to the nonmember.

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[58] See Special Study, pt. 4, 216.

[59] "Execution" refers to the actual work of making a trade on the exchange floor. The term "clearance" is used to describe the function of receiving and delivering cash and securities, and the accompanying paper work. As the Special Study points out, pt. 2, 297:

"In order to execute a trade on the NYSE without the assistance of another member a member firm must have a direct wire to a partner on the floor acting as a floor broker. In order to clear a trade executed on the exchange without the assistance of another member firm, a member firm must have a 'back office' operation within a reasonable distance of the exchange to facilitate delivery and receipt of tickets and securities, although clearing by mail is now permitted under specified circumstances. Member firms without execution and clearing facilities must channel their exchange orders through New York member firms possessing them."

[60] For execution and/or for clearance on orders received from members the NYSE prescribes minimum rates of commission which are lower than those which nonmembers must pay. See Special Study, pt. 2, 297–298.

[61] The nonsales services that the funds buy (see pp. 163–164, supra) with their disposable brokerage are almost always provided by NYSE members. Hence the funds seldom have any reason other than sales for wishing to direct brokerage to a non-NYSE firm.

If the nonmember is a member of a regional exchange there is a wider scope for such reciprocation. In such a case the NYSE member can place regional business with the nonmember to whom he owes "courtesy" commissions.[62] If the nonmember is obligated to a member for such services as research, Wire connections, clearance, and sales promotional materials,[63] the nonmember can discharge some portion of that obligation by having the funds channel some brokerage orders to the NYSE member who is serving him. However, the extent to which NYSE members can supply services to nonmembers in return for the NYSE business generated or controlled by the latter is limited by a series of informal exchange rulings, known as its "commission law," under which some of these arrangements have been deemed impermissible rebates.[64]

(b) The give-up

(i) Introduction.—The most obvious way of spreading the funds' commissions among a number of brokers is to have the broker who receives the commission for handling a single order give portions of that commission to other brokers. Thus, brokers can receive portions of a commission even if they had no connection with the transaction that produced it. The divisible character of brokerage commissions under the rules of the exchanges is the key to the funds' ability to make cash payments to numerous broker-dealer recipients who sell fund shares to the public and also supply certain other services to the funds and their managers, but who play no part in handling the portfolio transactions of the funds.

A broker who surrenders a portion of his commission to another is said to "give up" the surrendered portion. "Give-ups" are of two kinds. One kind, the traditional correspondent relationship, involves a division of compensation where there has-been an actual division of labor among two or more brokers in the handling of a particular transaction. Thus, if a broker who has secured a customer through personal contact, investment advice, or by providing custodial or other services, receives an order from that customer which he is unable to execute because he has no executing and clearance facilities of his own, he can forward the order to a second broker for execution and clearance. The second broker may execute the order himself. However, he may be too busy on the exchange floor with other orders, and in these circumstances he will delegate the actual execution to a floor broker who spends all of his working time on the floor and who specializes in executing orders for other brokers but does not maintain

[62] On occasion such orders may relate to securities listed only on the regional exchange. But because of the limited public interest in the regional exchanges' solely traded securities, few of the r[illegible] t NYSE members transmit to "regional-only" members involve such securities. Generally, t[illegible] o[illegible] involves a dually traded security which the NYSE member could execute on the NYSE. Moreover, the NYSE member may also be a member of the regional exchange on which the order is executed. As said (pt. 2, 308): "* * * the NYSE member is generally able to handle directly, and at least as effectively, the business he places with his reciprocal partner."

[63] There are several NYSE firms that prepare sales and training literature as well as reference materials useful to those who sell mutual funds. See Special Study, pt. 4, 119 121, 124-139, 220-223. Until recently broker-dealers could pay for these materials entirely by means of commissions. Now, however, the NYSE requires the firms who prepare the material to receive a cash price for it that covers production and distribution costs. CCH NYSE Guide par. 2440A.16. Nevertheless, this service may still produce some commissions for these firms.

Adviser-underwriters who sell through so-called "captive sales forces" (see ch. 11 at p. 56, supra) also use the materials referred to above. Accordingly, such adviser-underwriters have sometimes placed orders with the NYSE firms that supply these publications.

[64] Cf. the case of the mutual fund sales materials duscussed in the immediately preceding footnote.

office facilities necessary to clear them.[65] The commission may be divided among the broker who obtained the order, the second broker who arranged for the delivery of the securities from the seller's broker and handled much of the paperwork, and the floor broker who made the actual purchase on the exchange floor.[66] Give-ups resulting from traditional correspondent relationships have not posed basic regulatory problems.

The other kind of give-up is directed by the customer rather than arranged by the executing broker and is paid to a broker who has nothing to do with the transaction. In the typical customer-directed give-up, the customer places an order with a broker on condition that even though he will handle the entire transaction he will pay cash amounting to a portion of his commission to one or more other brokers who—whether known or unknown to him—have had no connection with the transaction. The customer-directed give-up has been used extensively by the funds. It permits them to entrust the execution of their portfolio transactions to a selected few brokers in whom they have special confidence and to reward with substantial cash payments the far larger group of brokers that distribute their shares.[67]

(ii) On the *New York* Stock Exchange.—Give-ups derived from commissions generated directly by NYSE transactions can be paid only to NYSE members.[68] Most NYSE member firms are willing to give up as much as 60 percent of the commissions on institutional orders to such other member firms as the institutional customer directs. And some of them make a special effort to attract such business by letting it be known that they stand ready to surrender 70 percent or even more of their commissions to any NYSE firm or firms designated by the customer.

The NYSE prohibition against the sharing of brokerage commissions for transactions executed on that exchange between members and nonmembers severely impairs the ability of mutual funds to utilize brokerage to reward their nonmember dealers for sales of fund shares. The disparity in the amount of brokerage available for sales compensation between NYSE members and nonmember dealers has led to considerable discontent. One dealer stated in a letter to the Commission:

> A nonmember dealer (not NYSE) works his head off to create millions in brokerage business—and services the funds' clients for years and years in dozens of ways but can't get cash for this extra service. This is wrong![69]

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[65] Floor brokers are sometimes known as "$2 brokers" because $2 was at one time the standard floor brokerage fee. Under present rules the average floor brokerage fee is about $3.50 per 100 shares. On floor brokers generally, see Special Study, pt. 2, 46-47, which points out that:

"In recent years, certain two dollar brokers have specialized in handling large orders which would normally occupy too much time of the commission house broker, Having achieved reputations for their ability in executing such orders quickly and without unduly affecting the market, these brokers come to know possible buyers and sellers of 'blocks,' and when they receive an order they may be able quickly to locate interest on the other side and arrange to match or 'cross' the orders." (Footnotes omitted.)

[66] For the manner in which the commission would be allocated among the three brokers, see Special Study, pt. 2, 297-298.

[67] The Special Study found that aside from mutual funds, life insurance companies were significant users of the give-up devise, but they used it to a lesser extent than the funds did (Special Study, pt. 2, 863). With respect to allocation of brokerage by institutions other than mutual funds, the Special Study noted:

"Life insurance companies mentioned that they try to allocate business to those broker-dealers who, as agent for the issuer or as principal, bring them private placements of various types of securities or give them participations in underwritings. Purchase of insurance from the company did not appear to be a significant factor. For colleges, consideration of the 'old school tie'—the interest of the broker in the college and the help he gives it—plus the providing of opportunities for private placements were the most important factors mentioned". (Special Study, pt. 2, 862.)

[68] NYSE Constitution, art. XV, sec. 1 and NYSE rule 369. See Special Study, pt. 2, 301-302.

[69] Special Study, pt. 4, 226.

(iii) On the regional exchanges.—Regional exchanges compete with the NYSE for mutual fund transactions in dually listed securities by providing channels for transmitting fund brokerage income to members of the regional exchanges and over-the-counter dealers who sell fund shares. Six of the seven regional exchanges permit their members to make cash payments to any member of the NASD out of commissions received.[70] This circumstance has led fund managers to distribute extra cash to over-the-counter retailers by sending portfolio business to the regional exchanges that would otherwise have gone to the NYSE. The Special Study found that the load funds made far more extensive use of the regional exchanges than did other types of institutional investors. The Study suggested that "the basis for this preference appears to lie in the 'give-up' or directed split of commissions." [71]

Mutual fund use of the regional exchanges has increased since the Special Study surveyed the regional exchanges. The volume of trading on the regional exchanges as well as the regional exchanges' relative share of total exchange dollar volume has risen considerably since 1962, and this rise is, in significant part, due to the funds' increasing use of the regionals to facilitate the payment of extra cash compensation to dealers who sell fund shares.[72]

The large orders that the funds usually place can seldom be matched on the floor of a regional exchange with either an order of corresponding size or a sufficient number of smaller orders to permit the execution of a trade. Thus, fund orders on regional exchanges are given either to an NYSE member firm which is also a regional exchange member or to one of a small number of regional-only members who specialize in large transactions and are known for their skill in finding the other side to large transactions. This type of brokerage skill does not involve the actual execution of an order on the floor of the exchange, but an awareness of the possible buying or selling interest of other large institutional investors in the security involved.

When a regional exchange member has "found the other side," settled the price, and arranged for the transaction, he instructs a floor broker on the regional exchange[73] to sell a specified quantity of a particular security on behalf of a designated seller at a prearranged

[70] Virtually every independent broker-dealer who sells fund shares is an NASD member. See ch. II at p. 62, supra.

The Detroit Stock Exchange was the first exchange to permit its members to give up to nonmember dealers. In 1950 that exchange amended its rules (Detroit Stock Exchange rules, ch. VII, sec. 9) so as to provide that "members may transact business for non-members who are members of the National Association of Securities Dealers, Inc. * * * for a commission of not less than 60% of the minimum commission * * *." Mutual fund business had not attained its present proportions in 1950 and appears to have had little to do with the Detroit Stock Exchange's decision to depart from the policy against commission splitting with non-members to which all national securities exchanges had theretofore adhered. The motivation was simply a desire to attract the business in dually traded securities (see P. 158, supra) of over-the counter dealers by offering such dealers a way in which to derive some income from transactions of their customers in listed securities. This tends to mitigate the economic disadvantages which their lack of access to an exchange market produces. By the time of the Special Study the Pacific Coast and the Cincinnati Stock Exchanges were also permitting their members to divide commissions with nonmembers. (Special Study, pt. 2, 299-300.) Since the publication of the Special Study, the Boston, Pittsburgh, and Philadelphia-Baltimore-Washington Stock Exchanges have amended their rules so as to enable their members to divide commissions with NASD members.

[71] Special Study, pt. 2,881. See also id 980–1019.

[72] Some fund managers have suggested that fund use of the regional exchanges may also be related in part to a desire for secrecy. They reason that although transactions on the regional exchanges are publicized in mncb the same fashion as those on the NYSE and on the Amex, the financial community pays little attention to trading in "out-of-the-way places" so that a large transaction that would have been bound to attract attention on the NYSE may go unnoticed if consummated on a regional exchange. Others maintain that traders are well aware of the activity on the regionals.

It would seem that a greater measure of secrecy can be obtained on the third market where there is, as yet, no tape or other means of current disclosure of Prices but where there can be no give-ups for sales of fund shares. See pp. 159–161, supra. In any event, the execution of block transactions in particular securities by large institutional investors could well be material to the informed investment decisions of other participants in the market. Avoidance of publicity for such transactions could well be inconsistent with the public interest.

[73] On floor brokerage, see pp. 169–170, supra.

price and to buy the same quantity of the same security at the same price on behalf of a designated buyer. A transaction of this type is known as a "cross". Each side to the transaction pays—and under the exchange rules must pay—a full exchange commission.[74]

A cross is nothing more than the formalization on the exchange floor of a transaction that has previously been negotiated and, as a practical matter, effected elsewhere.[75] A small portion of the resulting commission (usually about 10 percent) goes to the floor broker. The balance is paid to the broker who actually brought the parties together and he, in turn, pays an agreed portion to the over-the-counter dealers and/or regional-only members whom his clients wish to benefit for services unrelated to the transaction.

4. *Impact of mutual fund reciprocal and give-up practices*

The Special Study observed that "[r]eciprocity, or 'doing business with people who do business with you,' is an accepted custom of the business world in general, and the securities industry is no exception."[76] The Study noted, however, that reciprocal business practices in the allocation of mutual fund brokerage commissions take on a unique character. Although the commissions are generated by fund portfolio transactions and are paid by the funds, their use as extra compensation for sales of fund shares benefits the adviser-underwriters and the retail sellers of fund shares rather than fund shareholders.

Both the Wharton Report and the Special Study questioned whether fund brokerage commissions should be a factor in the competition for sales of fund shares.[77] Since the publication of these reports, the increasing amount of brokerage commissions paid by the rapidly growing mutual fund industry, coupled with the absence of a volume or institutional discount in exchange commission rate schedules, have made reciprocal and give-up practices in the allocation of mutual fund brokerage an even more significant factor in the competition for sales of fund shares. Mutual fund reciprocal and give-up practices also have drawn substantial volume away from the primary markets. Fund managers appear to have placed greater emphasis on the use of brokerage commissions to compete for dealer interest in promoting the sale of their funds' shares, and dealers have become increasingly aware of, and have made greater demands for, the extra sales compensation obtainable from fund brokerage.

(a) Use of brokerage commissions to benefit the funds

(i) *Reducing advisory fees.—As* has been noted, subsidiaries of four adviser-underwriters that maintain their own retail sales forces—among them three of the largest, Investors Diversified Services, Inc., Waddell & Reed, Inc., and Channing Financial Corp.,[78] as well as the smaller Imperial Financial Services, Inc.—are now members of the Pacific Coast Stock Exchange." These subsidiaries execute orders for the funds on the Pacific Coast Stock Exchange.[80] More

[74] In almost all circumstances, all exchanges have required their members to charge each side a full commission.

[75] Crosses are not peculiar to the regional exchanges. They are very important on the NYSE and on the Amex as well.

[76] Special Study, pt. 4, 233.

[77] Wharton Report 33; Special Study, pt. 4, 229, 233–235.

[78] Channing Financial Corp. is a holding company which owns Van Strum & Towne, Inc., the adviser to, and Channing Co., Inc., the underwriter of, the funds in the complex. The broker-dealer which is a member of the Pacific Coast Stock Exchange is a subsidiary of Channing Co., Inc.

[79] Ch III, pp. 109–110, supra.

[80] Thk subsidiaries are: Investors Diversified Services, Inc.'s, IDS Securities Co.: Waddell & Reed, Inc.'s, Kansas City Securities Co.; Channing Co., Inc.'s, Emmett A. Larkin Co.,' Inc., and Imperial Financial Services, Inc.'s, Imperial Securities, Inc.

important, however, they obtain a considerable amount of nonfund business from broker-dealers who are dual members of the Pacific Coast Stock Exchange and other exchanges in return for fund brokerage business on other exchanges, primarily the NYSE. All the net profits of IDS's subsidiary and about 40 to 50 percent of the net profits of Waddell & Reed's and of Imperial Financial Services' subsidiaries have been applied to reduce advisory fees payable by the funds in those complexes.[81]

Widespread emulation by institutional investors of the precedent set by these four complexes could have a marked effect on the economics of the securities industry. Within the framework of the existing commission rate structure it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions. However, among dealer-distributed funds the important role that portfolio brokerage plays in the competition for dealer favor has kept fund managers, with few exceptions, from using exchange memberships to reduce costs of the funds.

Similar competitive factors have also operated against the use, for the benefit of the funds and their shareholders, of regional exchange rules permitting give-ups to any member of the NASD on transactions executed on those exchanges. It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds.[82] Unless and until such procedures become widespread, any adviser-underwriter to a dealer-distributed fund who chose to utilize fund brokerage in this manner would place itself at a disadvantage in competing for the interest of nonmember dealers in selling the fund shares which it distributes.

(ii) *Allocation of brokerage commissions between sales and services.*—The allocation of fund portfolio brokerage to reward dealers for sales of fund shares is frequently justified on the ground that, given the present exchange minimum commission rates, the funds can derive no other benefit from their brokerage. However, the longstanding practice of the Broad Street Complex [83] and the recent actions of IDS, Waddell & Beed, Inc., and Imperial Financial Services, Inc., with respect to their brokerage business belie that assertion. Moreover, as noted above, advisers to most mutual funds allocate varying portions of fund brokerage commissions to pay broker-dealers for pricing services with respect to fund shares, wire facilities, and supplementary investment advisory services. Although funds and their advisory organizations may differ in their need for the services broker-dealers supply in return for brokerage commissions, the need to use brokerage to stimulate the sale of fund shares may tempt a fund adviser to skimp on the allocation of fund brokerage for nonsales services. His interest in promoting sales of fund shares and the importance of brokerage commissions as compensation for such sales make it difficult for an adviser to reach that judgment solely on the basis of the interests of the fund and its shareholders.

[81] Channing Financial Carp. has not yet declared whether and to what extent, the funds managed by it will realize savings from profits made by its subsidiary from exchange commissions.
[82] Alternatively, the hnd itself could form a broker-dealer affiliate to which it could direct give-ups. If this course were followed—and no fund now does so—the give-ups would inure to the direct benefit of the fund's shareholders.
[83] See ch. 111, pp. 106–108, supra.

The potential harm to the funds' interests is most acute for funds which are neither large nor part of a large investment company complex. Generally speaking, the smaller the fund the larger the portion of its brokerage that must be allocated for essential services, such as pricing, as well as the supplementary investment advisory service available from broker-dealers. For example, funds have equal needs for the continuing determination of their net asset value and may be equally interested in a particular analyst's views on a given industry—but a $300 million fund is likely to have considerably more brokerage available to pay for these supplemental services than a $50 million fund which, in turn, will have more available than a $10 million fund. The smallest of these funds is likely to have to devote all of its brokerage to such nonsales services. However, the middlesized and larger funds are likely to be able to direct portions of their portfolio brokerage to dealers who sell their shares. The middle-sized fund, once having entered this competition for dealer favor, is at a competitive disadvantage with larger funds which have more brokerage available for such purposes.

(b) Impact on portfolio management

The use of brokerage commissions in the competition for sales of fund shares can have harmful effects on the management of fund portfolios. Because such competition gives advantages to managers of funds that engage in active trading, it can create pressure for rapid turnover of portfolios—unwarranted by investment considerations—for the purpose of generating brokerage commissions.[84]

Such churning of an investment company's portfolio is a serious violation of the antifraud provisions of the Federal securities laws, as well as a "gross abuse of trust" under the Investment Company Act.[85] However, obtaining evidence of churning frequently may require an inquiry into fund managers' motivations. It is almost always possible to give a number of plausible-sounding "investment" reasons for a program of buying and selling that was primarily designed—or largely influenced by the desire—to generate brokerage commissions.

The portfolio turnover rates of mutual funds are on the average significantly higher than those of other types of institutional investors and the turnover rates of some funds are far above the industry average. A high portfolio turnover rate may result from a bona fide judgment that a policy of active trading is most likely to lead to optimum investment performance, especially during periods of great volatility. But it may also result from the managers' decision to generate a substantial volume of brokerage commissions for the purpose of stimulating the sale of new shares. Moreover, constant buying and selling may be the consequence of a complex and ever-changing blend of investment analysis and share-selling considerations.

The managerial discretion of those who administer the funds should be exercised solely in the interests of the funds, free of the pressures generated by the use of brokerage commissions to promote sales of fund shares. The increasing extent to which brokerage commissions are used to compensate retail sellers of fund shares tends to tarnish the

[84] Similarly, competitive pressures and the difficulty of channeling reciprocal brokerage and give-ups to nonexchange members may influence a fund manager's decision to purchase shares of an underwriting of securities from, or to acquire a block of securities offered by, a dealer in fund shares.

[85] Sec. 36.

integrity of the investment advisory function contrary to the best interests of the advisers, the funds and those who invest in them.

(c) Improper executions

The use of brokerage commissions to reward dealers for sales of fund shares also subjects fund managers to pressures that can result in the "improper" execution of fund portfolio transactions. Executions are improper whenever a fund fails to seek the best price available in connection with the purchase or sale of securities. Equally improper is any execution in which unnecessary charges are paid to execute the transaction.

The customer-directed give-up tends to engender improper executions. The fund manager which regularly insists on substantial give-ups by brokers is less likely to receive as favorable a response to its indications of interest in large blocks than are other institutional investors, including other funds, which do not ask for give-ups or ask for smaller give-ups. Where several institutions indicate substantial buying interest to a block broker who subsequently locates selling interest sufficient to satisfy only one of the prospective purchasers, the broker is most likely to call the investor which will permit the broker to retain all or most of his commission. The result may be a sacrifice of opportunity for superior portfolio executions by those funds requiring the most give-ups.

Indeed, the fund managers' interest in give-ups sometimes makes them unable to consummate any transaction at all. Cases have been reported to the Commission's staff in which one fund wished to buy and another wished to sell a block of a security and in which the parties were able to agree on a price but where give-up considerations proved a fatal stumbling block. The seller insisted on one stock exchange because that was the one through which its managers could satisfy their give-up obligations. The buyer, on the other hand, was quite as insistent on another exchange because its managers wished to generate commissions—not just on any exchange—but on that particular exchange, so that the transaction would produce give-ups for some firm or firms that belonged to it. Thus, investment considerations are subordinated to the fund managers' interest in maximizing sales.

(i) *Transactions in listed securities—Choice of market.—As* previously noted, purchasers and sellers of large blocks of securities sometimes are able to obtain better prices for NYSE listed securities by executing transactions in the over-the-counter or third market than through exchange members who have had to charge a full brokerage commission to each side of the transaction. Since there is no fixed schedule of minimum commissions or markups and markdowns for over-the-counter transactions,[86] third market transactions cannot properly provide give-ups for dealers who have sold fund shares.[87] However, the lack of give-ups on third market transactions compared with the wide scope given them on regional exchange transactions has led mutual funds to trade more on the regional exchanges than other large institutional investors and, as noted above, significantly less in the third market.[88]

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[86] Registered national securities associations of over-the-counter market dealers are prohibited from fixing a schedule of minimum commissions or charges to the investing public. Exchange Act, sec. 15A (b) (8).
[87] For a discussion of give-ups in over-the-counter transactions, see generally pp. 178–179, infra.
[88] Special study, pt. 2, 881; see pp. 160–161, supra.

Both exchange member firms and firms which operate in the third market agree with the finding of the Special Study that mutual fund adviser-underwriters prefer to execute transactions on national securities exchanges rather than in the third market. To obtain a larger share of mutual fund brokerage business, many NYSE and regional exchange firms have enlarged the number of regional exchanges to which they belong in order to utilize regional exchange rules which permit them to give up to any member of the NASD.

Some firms which have recently become regional exchange members are former over-the-counter brokers who had developed a substantial third market business in listed securities and achieved a wide reputation because of their skill in arranging, as brokers, block transactions for institutional investors. The commissions charged by these brokers before they became exchange members were subject to negotiation with the parties to the transactions. Their usual commission was one-half of a full commission from each customer. One such broker testified that at times his commissions were negotiated down to one-quarter of an exchange commission or less.

> Sometimes we do it away from the last sale and it is a large trade * * *.we will get down to an eighth of a point. And in certain instances if our trades are really large we may do it net on one side and just an eighth on the other side * * *. We will not do a trade for less than an eighth * * *.

Prior to joining an exchange these brokers found that despite the fact that mutual funds could execute block transactions more cheaply through them than through exchange members, they had considerable difficulty in dealing with the funds. As one dealer testified:

> Basically our business was designed just to save people money. The mutual fund business competition is, I guess, so great to get reciprocity out to the people that are selling their shares [that] many of the funds asked us to join the * * * [name] Stock Exchange., We resisted the thing for a couple of years.
>
> One of our competitors [name] * * * [was] I think the first to join the * * * [name] Stock Exchange, and finally competition was coming into our business and we simply had to join the * * * [name] Stock Exchange to keep doing block business with the funds.

As exchange members, these brokers are required to charge a full commission to each side of a transaction for the execution of brokerage orders in securities traded on the exchange. The higher charges and the regional exchange rules which have permitted directing a portion of the commission to nonmember dealers who sell fund shares have enhanced their ability to obtain business from mutual funds. However, exchange membership may have had some adverse effect on their nonfund business. One broker testified:

> It has inhibited the business to a certain extent, insofar as when you are dealing with customers who are not mutual funds and not dealers and not members of the NASD. For example, banks or insurance companies—you have to charge them full stock exchange commissions and the banks and the

insurance companies are getting close lately and they don't like to pay full commissions anymore, and that stops some trades.

Another broker stated, however, that despite the necessity of charging nonfund clients a full commission, he was able to retain a substantial portion of his business with banks and pension funds:

They obviously couldn't care less about the * * * [name] Stock Exchange, but by the same token we—then we realized the availability of the block is really ultimately the most important thing, so we persuaded some of the people that couldn't care less about reciprocity * * * they had simply had to give up the full commission on the stock exchange trade. * * * But [these] institutions basically want to save money.

Competition for mutual fund portfolio transactions from exchange members who are permitted to engage in reciprocal and give-up practices induced one large dealer in the third market to consider the adoption of its own minimum commission rate schedule. The schedule would have provided for commissions in large transactions higher than those it had been charging but substantially lower than exchange minimum commission rates. The firm also proposed to allow institutional customers to direct the give-up of specified portions of the commission to any NASD member. The firm stated that its competitive position was affected adversely by reciprocal business which had developed in the exchange market and that it stood to suffer increasingly from any bar to competing in the give-up markets.

The legitimation of give-ups in over-the-counter transactions—even where, as here, one firm rather than a group of competitors is involved—would lead to higher costs of execution for all institutional customers. This dealer's proposal is eloquent evidence of the widespread reluctance on the part of mutual fund managers to execute transactions in markets which afford the funds better prices but do not provide for the give-up of commissions for sales of shares.[89]

(ii) *Transactions on national securities exchanges—Choice of executing brokers.*—Although recently mutual funds have been executing more of their portfolio transactions in NYSE listed securities on regional exchanges than they did formerly and although the third market sometimes offers opportunities for better executions than are obtainable on national securities exchanges, a substantial portion of most funds' portfolio transactions in NYSE securities must be executed on the NYSE because that is the primary market for such securities. As noted, fund managers generally believe that, while more than one broker is able to provide good executions, there are differences in executing ability among brokers.[90]

The need to reward retailers in fund shares exerts undesirable pressures on the selection of executing brokers for fund portfolio transactions. While give-ups can be used to reward nonexecuting NYSE firms for sales of fund shares or for other services, many member firms that maintain facilities to handle executions prefer to make use

[89] In some circumstances the use of a regional exchange rather than the NYSE may also result in a poorer execution. For example, there may be some orders on the NYSE specialist's book which would permit a portion of the block to be executed at better prices than those available through a regional exchange cross.
[90] See p. 168, supra.