of them and to enjoy the prestige that flows from their selection as an executing broker for a prominent institutional investor. For example, although one fund trader has stated that a particular NYSE member firm gives him better executicns than others, the fund adviser nevertheless feels compelled to execute fund transactions through other firms who are important sellers of fund shares and who demand an opportunity to participate in the execution of the fund's portfolio transactions. Of course, these are the larger firms those with clearing facilities and floor representation.

The choice of executing brokers, like many other aspects of fund management, is a matter for the fund managers' business judgment. The introduction of considerations relating to sales of fund shares in the making of such judgments, however, may be inconsistent with the managers' duty to obtain the best execution for fund portfolio transactions.

(iii) Transactions in over-the-counter securities.—A directed give-up of a portion of the commission charged for handling a transaction for a fund in the over-the-counter market would be a patent waste of investment company assets. Since the over-the-counter market in both listed and unlisted securities is a negotiated market, which is not governed by fixed prices or minimum commission rate schedules,[91] any willingness of the executing broker or dealer to allow his customer to direct a give-up of a portion of his commission or markup to dealers in fund shares in and of itself shows that a lower price or commission could have been negotiated. An example reported by the Special Study involved an over-the-counter purchase of 12,900 shares of an NYSE stock. The broker who executed the transaction charged a commission at the full NYSE rate ($5,800), but it retained only half of the commission and distributed the remaining $2,900 among 14 other nonmember broker-dealers designated by the fund's management.[92]

Improper executions in over-the-counter transactions also result whenever an investment company "interpositions" a superfluous broker-dealer into a transaction between the company and the brokerage firm from which it is buying, or to which it is selling, an over-the-counter security. The Special Study cited an instance where a fund underwriter instructed a dealer in its fund's shares to "sell" as agent for the fund 4,000 shares of unlisted portfolio securities to an NYSE firm which the fund underwriter had designated. Since the fund's management had itself found the buyer, the fund had no need for this dealer's services. Nevertheless its underwriter caused the fund to pay the dealer a commission of $800 as a reward for selling fund shares.[93] Another over-the-counter broker which specialized in arranging large block transactions devised a system of sub-brokerage designed to enable his mutual fund clients to direct give-ups of portions of portfolio brokerage commissions. Under this system the fund managers would place over-the-counter orders with a dealer in fund shares who, using his "brokerage judgment," would forward the order to this executing broker. Thus, the broker who really did the work, that is, the executing broker, paid a portion of his commission to a superfluous intermediary, the sub-broker.

[91] See pp. 158–159, supra.
[92] Special Study, pt. 4,227.
[93] Special Study, pt. 4, 227.

Interpositioning in instances such as these is clearly improper since the interposed broker performs no essential function in connection with the execution of the transaction. In such circumstances, the practice only increases the cost of execution to the fund.

As one mutual fund manager has said:

> If great care must be taken to obtain the best possible prices when commissions are not subject to negotiation, vigilance should be doubled when executing orders on which commissions are not fixed by an exchange and profits and prices are not fixed by an agreement or by a prospectus. Prices, profits, and commissions, if any, are all subject to negotiation in the over-the-counter markets. Certain brokers maintain a market in a limited number of stocks. They are considered to be the 'primary market' and ordinarily the best prices can be obtained from them. Therefore, if an investment company should ask a dealer who does not maintain a primary market to execute an order for an over-the-counter security, a second profit or commission would be added to the price that could have been secured in the primary market itself * * *.
>
> In an over-the-counter transaction, those who perform no service should not participate in commissions or profits and there should be no give-up arrangements with them. Obviously, if a negotiated commission or price allows for a give-up of a portion of the commission or profit, a better execution for the investment company could have been negotiated if no give-up had been involved.[94]

(d) Impact on mutual fund sales practices

Although most mutual fund dealers offer the shares of many different funds, often more than a hundred, most of them tend to concentrate their sales efforts in the shares of a relatively few funds. Many dealers maintain "recommended," "preferred" or "selected" lists on the ground that they represent the firm's judgment as to which funds offer the most promise of fulfilling their customers' investment needs. Salesmen are encouraged or instructed to recommend these funds to their customers, and sales of these funds' shares usually account for most of the dealers' fund business.

Competition for dealer favor is central to the promotional efforts among the underwriters of the dealer-distributed funds. A key factor in this competition is the judicious and selective allocation of the commissions generated by the funds' portfolio brokerage business. Some underwriters attempt to meet the demands of their dealers for a "fair share" of the fund's brokerage business by attempting to relate each dealer's share of that business to his contribution to the fund's aggregate new share sales. Other underwriters, however, proceed on the premise that their funds' share sales can best be stimulated by concentration and the strategic placement of portfolio brokerage.

Underwriters, for example, have encouraged fund dealers to organize special sales campaigns for the shares of the funds they distribute with the understanding that the funds will provide them with extra brokerage business or give-ups on all sales made during the campaign.

[94] Driscoll, *Procedures of Affiliated Fund and American Business Shares in Buying and Selling Portfolio Securities*, p. 14 (1965).

Some adviser-underwriters tend to concentrate the brokerage business at their disposal among a relatively few selected dealers with the understanding that those dealers will focus their sales efforts on the shares of the funds distributed by these adviser-underwriters. In some instances, they seek to obtain new dealers by the payment of cash give-ups in advance of any sales by those dealers.

Independent dealers in fund shares and their salesmen are in a position to offer—and often purport to offer—mutual fund investors the benefit of informed evaluations of the investment merits of a large number of funds. Customers are encouraged to—and frequently do—rely upon the dealer's recommendation in making their investments. The influence of reciprocal business and give-ups, which is hidden from their customers, tends to undermine the integrity of dealer recommendations. It tempts dealers to base their recommendations on the amount of portfolio brokerage that will be generated by selling shares of a particular fund rather than on the suitability of that fund to the investment needs of their customer.

(e) The competitive effects of reciprocal and give-up practices

(i) *Competition between small and large funds.*—To the extent that extra compensation for sales of fund shares promotes fund growth through sales of new shares, the use of brokerage commissions for this purpose directly benefits fund managers. As has been indicated, under present industry compensation patterns increases in fund size result in increased advisory compensation.[95] The funds and their shareholders, however, benefit only to the extent that fund growth reduces advisory fees and other operating costs or enables fund managers to build a stronger advisory organization. To the shareholders of some small funds these benefits could be substantial; to shareholders of larger funds and to the shareholders of those smaller funds which belong to large complexes, they may be less significant.

The use of brokerage commissions as compensation for sales of fund shares places small funds and small fund complexes at a distinct competitive disadvantage in connection with sales of fund shares.[96] Since large funds tend to have substantial advisory organizations, they have less need for supplementary investment advisory and other services available from broker-dealers in return for brokerage. Only a small portion of the large funds' brokerage commissions need be allocated for such services. On the other hand, payments for nonsales services furnished by broker-dealers often consume all of the brokerage commissions generated by small funds. Moreover, because large funds and large fund complexes are more important and more profitable brokerage clients than small funds, large funds are able to obtain more services for their brokerage dollars and are in a better position than small funds to negotiate higher give-up rates.

Small funds which have not achieved a widespread reputation among broker-dealers, salesmen, and customers are at a disadvantage in sales competition with large funds. The use of brokerage commissions in the competition for such sales adds to this disadvantage and tends to impede the development and the growth of small funds.

(ii) *Competition Between member and nonmember* dealers.—Mutual fund reciprocal and give-up practices have also operated to the

[95] See ch. III, pp. 88-90, supra.
[96] See pp. 166–167, supra.

disadvantage of those dealers in fund shares who are not members of the NYSE, particularly those who do not belong to any regional exchange. Since most mutual fund portfolio transactions are executed on the NYSE, whose rules permit give-ups only to its members, non-NYSE members are able to receive substantially less extra compensation for sales of fund shares than members.

To some extent, mutual fund utilization of regional exchanges has mitigated the disparity in extra sales compensation between NYSE members and nonmembers. However, since mutual fund transactions on regional exchanges consititute only a small portion of fund portfolio transactions, they are not sufficient to remove the disparity in compensation for non-NYSE members and particularly for those dealers who are not members of any exchange. Even those exchanges which permit give-ups to any member of the NASD do not allow nonmembers to receive a give-up as large as that permitted for members. Thus, one fund adviser-underwriter described nonmember dealers to the Commission's staff, as "the poor souls who have to stand in line shouting and screaming until the day comes when one of the funds buys a new issue." [97]

The extent of the disparity between the reciprocal and give-up compensation received by large and small dealers is illustrated by the recent study of the over-the-counter markets prepared for the NASD by Booz, Allen & Hamilton, Inc.[98] This study disclosed that in 1964 the 707 smallest broker-dealers of the 2,483 surveyed derived an average of less than $170 from give-ups and reciprocals or only 2.1 percent of their $8,000 average gross income.[99] Thus, while these firms derived almost 57 percent of their gross income directly from retailing mutual fund shares, their gross income from reciprocals and give-ups amounted to less than four cents for every dollar of direct mutual fund selling compensation that they received.

On the other hand, the seven largest firms derived only 2.2 percent of their almost $69 million average gross income from direct compensation for the sale of mutual fund shares. These firms, however, received an average of almost $690,000 from give-ups and reciprocals or about 1 percent of their average gross income.[100] While their give-up and reciprocal revenues were derived from both mutual fund and nonfund sources, it seems apparent they received much more extra compensation in relation to their mutual fund sales than did the smallest firms.

The inability of a nonmember dealer to benefit equally with exchange members from the execution of exchange transactions is attributable to the fact that the privilege of executing transactions on the national exchanges is limited to the members of the exchanges. Traditionally, however, this limitation has operated to the disadvantage of a nonmember broker-dealer only in competing for transactions in exchange-traded securities. Mutual fund reciprocal and give-up practices extend the advantages of exchange membership to the rewards available for selling mutual fund shares—sales which are effected without the use of the facilities of a national securities exchange.

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[97] If such a dealer has become a member of an underwriting selling group (because a fund manager has asked the managing underwriter to include that particular dealer or because of other reasons), he may receive compensation on a par with that received by others in the group.

[98] Booz, Allen & Hamilton, Inc., Over-The-Counter Markets Study prepared for the National Association of Securities Dealers ("Booz-Allen study") (Aug. 22, 1966).

[99] Booz-Allen study, 13 and app. D, table 1.

[100] Booz-Allen study, 13 and app. D, table 1.

(iii) *Competition among markets for listed securities.*—One of the principal policies underlying the Commission's regulation of the securities markets has been the promotion of fair and effective competition among the various securities markets.[101] As both the Senate Committee on Banking and Currency and the House Committee on Foreign and Interstate Commerce have noted, the Exchange Act [102] reflects an endeavor by Congress to—

> * * * create a fair field of competition among exchanges and between exchanges as a group and the over-the-counter markets and to allow each type of market to develop in accordance with its natural genius consistently with the public interest.[103]

As indicated above,[104] the pressure to pay broker-dealers additional compensation by means of give-ups and through participation in fund portfolio brokerage transactions for selling fund shares has resulted in a bias in fund managers' choices of markets for the execution of fund portfolio transactions. Quite apart from the potential neglect of fiduciary obligations which this bias fosters, it distorts competitive relationships among the securities markets in a manner inconsistent with the public interest.

The kind of competition among securities markets which is in the public interest is that which focuses on providing market mechanisms which facilitate the trading of securities at competitive prices and reasonable service charges. Allocating mutual fund portfolio brokerage as an additional reward for the sale of fund shares does not further this result. It furnishes incentives for paying service charges which are higher than might otherwise be necessary and for foregoing markets which offer a better price in favor of markets which provide better opportunities for the distribution of extra compensation to sellers of fund shares. Thus, such use of fund brokerage has resulted in a demonstrable shift in the competitive emphasis among the securities markets and among the members of the securities industry from that of providing market mechanisms which facilitate the trading of securities at competitive prices with reasonable service charges, to that of providing mechanisms which facilitate the broader distribution of the brokerage commissions paid by the funds.

5. *Existing controls over mutual fund reciprocal and give-up practices*

The problems posed by mutual fund reciprocal and give-up practices have been of increasing concern to State regulatory authorities, industry organizations, and the Commission. Each of these bodies has taken steps to mitigate some of the potential abuses that stem from such practices.

(a) State regulation

State securities administrators were among the first to express concern over the use of fund brokerage commissions in the competition for sales of fund shares. In 1949, the North American Securities Administrators ("NASA"),[105] an association of State, Canadian provincial, and Mexican securities administrators, adopted a resolution

[101] See *The Multiple Trading Case*, 10 S.E.C. 270 (1941).
[102] See sec. 12(f) of the Exchange Act.
[103] S. Rept. 1739, 74th Cong., 2d sess. (1936), p. 3; H. Rept. 2601, 74th Cong., 2d sess. (1936), p. 4.
[104] See pp. 175–177, *supra*.
[105] Formerly known as the National Association of Securities Administrators.

disapproving of attempts to promote mutual fund share sales through promises or agreements to give fund dealers brokerage business in addition to sales compensation provided for in dealer contracts.[106]

In **1952,** NASA adopted two further resolutions dealing with the use of fund brokerage commissions as sales compensation. One resolution attacked the "stockpiling" of give-ups, a practice whereby fund underwriters who have not immediately directed give-ups accumulate a backlog which they later distribute selectively among fund dealers. **A** second resolution condemned give-ups that result in a price less favorable than the fund would otherwise have received.

A number of States have patterned their rules with respect to mutual fund reciprocal and give-up practices after the NASA resolutions.[107] However, as indicated by the Special Study, "their impact on industry practices is limited by the problems of enforcement which hamper most State securities administrators * * *." [108] The disapproval of express understandings has not prevented the development of reciprocal business and give-up patterns by which sellers of fund shares are rewarded by the allocation of brokerage commissions on the basis of **a** rule of thumb understood by the parties. The disapproval of "stockpiling" has not had a widespread effect on industry reciprocal and give-up practices, since large funds and large fund complexes can generate enough brokerage commissions to permit 'selective distribution to fund dealers without the need for "stockpiling".

(b) The NASD

The NASD also has expressed some concern over certain types of compensation in addition to the regular dealer discount paid to dealers who sell fund shares. An interpretation of its Rules of Pair Practice limits the nature and extent of the extra compensation which its members may receive for selling mutual fund shares.[109] However, this interpretation has not been applied to reciprocal brokerage or give-ups allocated as compensation for sales of fund shares. Thus, the NASD's Rules of Fair Practice prohibit a dealer in fund shares from accepting a gift worth more than **$25,** but they do not place any limits on the dealer's receipt of cash give-ups as extra compensation for sales of fund shares.[110]

The Special Study raised questions with respect to the NASD's Rules of Fair Practice in this area,"' and the NASD has submitted

[106] Proceedings of the 32d Annual Convention of the National Association of Securities Administrators, p. 102 **(1949).**

[107] Alabama, Illinois, Kentucky, Maine, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, North Dakota, Ohio, Oregon, South Carolina, West Virginia, and Wisconsin.

[108] Special Study, pt. **4, 230.**

[109] This so-called "Special Deals" interpretation states that it is inconsistent with just and equitable principles **of** trade and a violation of the NASD Rules of Fair Practice for a member, its registered representatives, and other associated persons, to accept—or for a principal underwriter or its affiliated persons to give—directly or indirectly in connection with sales of fund shares "anything of material value" in addition to the dealer discounts or concessions set forth in the fund's current prospectus (NASD Manual, G–32). The NASD's recently issued guideline for administration of the "Special Deals" interpretation includes as examples of "anything **of** material value" gifts of more than $25 per person per year or of management company stock, loans, and sales commissions in addition to those described in the prospectus.

[110] The NASD also has adopted an interpretation of its Rules of Fair Practice with respect to dealer compensation of salesmen for sales of investment company shares. This interpretation, unlike the "Special Deals" interpretation, specifically recognizes that receipt **of** reciprocal brokerage and give-ups *is* part *of* sales Compensation since it includes **as** part **of such** compensation "a participation in brokerage commissions" (NASD Manual, **G–34).** The interpretation requires that the total compensation **of** a registered representative for the sale of fund shares "bear a reasonable relationship to the dealer discount set forth in the prospectus of the investment company and in the selhng group agreement of the underwriter."

[111] Special Study, pt. **4, 234–235.**

various proposals for strengthening them.[112] Although the NASD proposals, if adopted, would have eliminated some undesirable practices, they would have codified, and thus impliedly would have sanctioned, the use of fund brokerage as extra compensation for sales of fund shares. Consequently, the Commission deferred action on the proposals pending an overall evaluation in the light of this report.

(c) The national securities exchanges

The activities of the NYSE with respect to give-up and reciprocal practices have been limited to considerations affecting the administration and enforcement of its rules prohibiting direct rebates to nonmembers of brokerage commissions earned on exchange transactions executed for them. Regional exchanges, on the other hand, have been largely concerned with fashioning give-up rules that enable them to compete effectively with the NYSE, the Amex and the third market for fund portfolio transactions.

(d) The Investment Company Institute

Other industry efforts to control potential abuses that might result from mutual fund reciprocal and give-up practices are reflected in the Guide to Business Standards adopted in 1962 by the Investment Company Institute, the industry association to which the mutual funds which hold most of the industry's assets belong.[113] The Investment Company Institute has, as one of its purposes, the promotion of high ethical standards among its members. However, since it does not exercise statutory self-regulatory responsibilities, as do national securities exchanges and the NASD, it maintains no enforcement machinery and imposes no sanctions on members who do not choose to follow its Guide.

(e) Federal regulation—The need for action

Since the publication of the Wharton Report and the Special Study, the use of mutual fund brokerage as extra cash compensation for sales of fund shares has been the subject of extensive study and .consideration by the Commission. Information gathered from expanded disclosure and reporting requirements under the Act,[114] informal investigations, and discussions between Commission representatives and members of the securities industry regarding mutual

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[112] As noted in the Special Study (pt. 4, 231) in May 1961 the NASD asked the Commission's tentative approval of proposed amendments to its Rules of Fair Practice which would have prohibited: (1) any agreements or promises to give a brokerdealer any specified amount of brokerage business or brokerage commissions: (2) the allocation of brokerage commissions to any firm in an amount "greater than of disproportionate to the amount of brokerage commissions generally directed to other members in relation to their sales volume, * * *" and (3) the direction of brokerage Commissions to individual salesmen. In addition, the NASD proposed to require its underwriter members to "compile and maintain detailed information" on the portfolio transactions and brokerage Commissions of the mutual funds for which they act.

In late 1964 the NASD revised its proposed amendments. Their revised proposals would have prohibited: (1) interpositioning or any other arrangement which would result in any unnecessary additional costs to an investment company; (2) principal underwriters from directing commissions to individual salesmen for selling fund shares and (3) principal underwriters from offering other members, and other members from soliciting, a specified amount of brokerage commissions in reciprocity for such sales. In addition, the proposed amendments would have required principal underwriters to maintain, in such form as the Board of Governors of the NASD should prescribe, records showing reciprocal busmess known by them to have been allowed, directly or indirectly.

[113] Sec. 4 of the guide provides that no member shall "promise or intimate to a broker-dealer" that he will receive a certain amount of brokerage commissions "directly or *indirectly*" and that iio member should arrange for the allocation of brokerage commissions *to* a broker-dealer ';materially" disproportionate to that firm's sales of fund shares "without specific disclosure in the effective prospectus." Members are also enjoined from directing give-ups to broker-dealers in over-thecounter transactions.

[114] Form N-1R, the new annual reporting form for most management investment companies, contains a number of items calling for disclosure of practices with respect to the allocation of brokerage commissions and the possible impact of such allocations on portfolio management. *See* items 1.25, 1.31, 2.17, 2.18, and 2.28 of Form N-1R. Investment Company Act Release No. 4151 (Jan. 25, 1965). The Commission has also placed additional emphasis on disclosures pertaining to brokerage allocations in mutual fund prospectuses and proxy statements.

fund reciprocal and give-up practices has confirmed and emphasized the problems raised by the Wharton Report and the Special Study. Since this report deals largely with mutual funds, it has discussed use of mutual fund brokerage as additional sales compensation primarily in terms of its impact on funds and their shareholders. It should be emphasized, however, that other institutional investors employ similar techniques. Apart from the purposes of, and impact on, such investors, the Commission is of the view that certain aspects of these practices, particularly the customer-directed give-up, impair the orderly and proper functioning of the securities markets themselves.

(f) Customer-directed give-ups

In the over-the-counter markets, where brokerage costs are subject to negotiation, give-ups of commissions to brokers who perform no necessary function in connection with a transaction have long been recognized as improper and illegal. Give-up practices have been tolerated in the exchange markets only because brokerage costs are fixed by the exchange minimum commission rate schedules. They have become widespread because these schedules have not distinguished between large or small orders and the services sought by or provided to large institutional investors.

Exchange give-up rules may have been originally designed to provide for a reasonable sharing of commissions among those who combined to perform services for customers through traditional correspondent relationships. However, mutual fund give-up practices are wholly inconsistent with this purpose. They permit mutual fund managers to distribute the commissions that the funds pay among securities firms which have nothing to do with the transactions on which the commissions are earned and for services which are of little or no relevance to the interests of the funds' shareholders.

Customer-directed give-ups raise questions as to the propriety of the commission rate schedule itself. Assuming that a minimum commission schedule is necessary and appropriate to effective and efficient operation of an exchange, the commission rate structure should be designed to compensate brokers fairly for the services they perform and to provide equitable treatment for various classes of customers whose use of exchange facilities is basically similar. As existing exchange rules recognize, it should not give direct or indirect discriminatory rebates to particular classes of customers.

Mutual fund give-up practices are inconsistent with these principles, They create rebates not to the brokerage customer, the fund itself, but to its managers who are in a position to direct the fund's brokerage to maximize sales of fund shares. Moreover, the availability of such rebates creates distortions and artificial devices in the securities markets. Give-up practices may facilitate a wider distribution of fund brokerage, but in the process they interfere with the orderly functioning of the markets, the effective execution of customer orders and the channeling of competitive forces for the benefit of public investors, and, as has been noted, they have other undesirable effects on the mutual fund industry.

The give-up is the principal device whereby fund managers are able to channel brokerage commissions to large numbers of dealers in fund shares who do not and are not in a position to perform any useful or necessary function in connection with the transactions on which the commissions are earned. Hence the give-up is in large measure responsible for the increasing importance of brokerage commissions in the competition for sales.

Accordingly, the Commission has given notice that it believes that exchange rules must be changed so as to preclude customer-directed give-ups. Since competitive pressures among participants in give-up practices may deter any one of the exchanges, acting alone, from taking the initiative in this area, concerted action by the exchanges, the NASD and the Commission will probably be necessary. To provide a comprehensive and uniform approach to this matter, the Commission may find it essential to exercise its rulemaking powers under the Exchange Act.

Rules abolishing customer-directed give-ups should reach all existing or future practices which achieve the same purposes now accomplished by present mutual fund give-up practices. Such rules need not interfere with commission splitting among members as a result of traditional correspondent practices whereby the broker receiving an order has a bona fide brokerage relationship with the customer but shares the commission with a correspondent who executes and clears the transaction through the facilities of an exchange. Such commission-splitting is confined to brokers who share the duties, responsibilities, and obligations involved in the handling of the transaction on which the commission is earned. It is quite different from mutual fund commission-splitting which is directed by the fund managers for the purpose of paying brokers for services extraneous to the brokerage function.

The abolition of customer-directed give-ups would appear to have only a slight effect on the gross income of the securities industry. The Booz-Allen study indicates that combined give-up and reciprocal business from all sources accounted for only 2.5 percent of the 1965 gross income of the 2,453 firms studied.[115] Gross income from give-ups and reciprocals from all sources exceeded 5 percent of *gross* income for only one size group of broker-dealers — the 37 dealers whose gross income ranged from $185,000 to $200,000 in 1964.[116]

(g) Reciprocity and exchange commission rate schedules

Reciprocal business practices, i.e., the selection of executing brokers by mutual fund managers on the basis of the brokers' sales of fund shares, raise slightly different issues. The adverse effect of reciprocal practices on the functioning of the securities markets, as distinct from their effect on mutual funds and their shareholders, is not as clear as in the case of give-up practices.

Reciprocal practices, however, do have an adverse effect on mutual funds and their shareholders. They exert pressure upon the exercise of managerial discretion in allocating brokerage between sales and nonsales services, in formulating investment policies and decisions and in executing portfolio transactions. They exert a hidden influence on retail dealers' recommendations to investors and result in unwarranted competitive disadvantages for small funds and small dealers, particularly nonexchange dealers, in competing for sales of fupd shares with large funds and large member dealers. They also channel the competition for the funds' portfolio brokerage business among markets

[115] Booz-Allen study 31.
[116] Booz-Allen study: 13.

and brokers in a manner which benefits fund managers rather than mutual fund shareholders.

It probably is not practical to deal with reciprocity by modifying exchange rules to prohibit these practices except in situations where brokerage allocation is employed to evade the prohibition of give-ups. The Commission believes, however, that the adverse effects of mutual fund reciprocal practices can be substantially mitigated through changes in exchange minimum commission rate schedules to provide a discount for the execution of large block transactions or otherwise take into account the generally lower costs to brokerage firms of executing transactions for the larger institutional investors. Existing give-up practices show that exchange members find it profitable to execute mutual fund portfolio transactions for 40 percent or less of minimum commission rates. These savings can be passed to the multitude of small investors who participate in the securities markets through institutional media if exchange minimum commission rate schedules are revised to provide for meaningful volume or institutional discounts.

Accordingly, the Commission has advised the national securities exchanges that it considers the question of changes in commission rate schedules to be closely related to that of the adoption of rules prohibiting customer-directed give-ups. It has asked the exchanges to consider appropriate changes in their commission rate schedules for the benefit of small investors who participate in the markets through institutional media. Such changes should not restrict the normal discretion of a customer or broker with respect to the timing of orders and the manner of executing them. Institutional customers should not be placed in the position of having to execute substantial orders in short periods of tune contrary to the dictates of prudent investment judgment in order to reduce their brokerage costs. A meaningful volume or institutional discount therefore requires consideration of a number of factors including the amount of such discounts, the appropriate breakpoints for such discounts and the definition of an "order."

Although the subject of volume or institutional discounts is closely linked to the give-up problem, there are differences. In the Commission's view it is essential that uniform action be taken to abolish the customer-directed give-up on all exchanges. It is not as clear that the nature and extent of volume or institutional discounts necessarily should be uniform among all exchanges. More important, concurrent resolution of both matters is not a necessary condition to the resolution of one or the other. The Commission has, however, initiated discussions of both matters with the exchanges. It is important that appropriate solutions to these matters be carefully considered and promptly resolved.

The Commission will consider the need for other changes in connection with the introduction of a volume or institutional discount. However, at the present time there is no evidence that a volume or institutional discount will require any such changes.

(h) Other action

There is good reason to believe that the steps proposed to be taken With respect to the directed give-up and the volume discount will substantially reduce the adverse consequences to the funds and their stockholders of using fund brokerage as extra compensation for selling fund shares. It is possible, however, that additional steps may be necessary to deal with these problems. For example, the abolition of customer-directed give-ups and the introduction of a volume discount in exchange transactions may lead some mutual fund managers who wish to reward a number of brokers for services unrelated to the handling of brokerage orders to fragment the funds' orders among many transmitting or executing brokers. The Commission believes that such fragmentation normally would be inconsistent with the legal duty of fund managers to seek the best execution for their clients. The Commission will exercise its jurisdiction to enforce this basic fiduciary duty.

If experience shows that the steps outlined above have failed to curb the adverse consequences to investors of the link between the mutual funds' share-selling activities and their portfolio brokerage business, another alternative, which the Commission is not yet prepared to recommend, will have to be considered. This would be to prohibit broker-dealers from acting as brokers for or sharing in the brokerage commisssions paid by funds whose shares they sell. Although indirect and subtle reciprocal arrangements may nevertheless arise,[117] such a divorce of share selling from portfolio brokerage may be the most effective way to curb the use of fund brokerage in the competition for sales of fund shares. However, such an approach would limit the number of brokerage firms from which smaller funds or complexes could acquire supplementary investment advice and other nonsales services. To some extent it would also limit fund managers in their choice of broker-dealers for fund portfolio transactions. This might affect the funds' portfolio transactions since cases could arise in which the dealers who had chosen to continue to retail. fund shares were best able to handle particular transactions. Accordingly, the Commission will defer consideration of this alternative until it has had an opportunity to evaluate the effects of the steps it now proposes to take.

D. BROKER-AFFILIATED INVESTMENT COMPANIES

A substantial number of investment companies are affiliated with broker-dealers. For some companies the affiliation is limited to members of their boards of directors who are partners of or otherwise associated with brokerage houses. For others the affiliation is much closer; the adviser-underwriter is itself, or its controlling persons are, closely associated with an established brokerage firm which regularly executes company portfolio transactions. This section is concerned with that closer type of broker-dealer affiliation.

The investment companies which are closely affiliated with an exchange member include several large mutual funds, such as National Investors Corp. and Broad Street Investing Corp., and the two largest diversified closed-end investment companies, Tri-Continental Corp.,[118] and the Lehman Corp.[119] A number of smaller funds—for example, Energy Fund, Inc., Pine Street Fund, Inc., DeVegh Mutual Fund, Inc., Philadelphia Fund, Inc., and Oppen-

[117] See pp. 168-169, supra. For a discussion of such complex reciprocity practices, see Special Study, pt. 2, 302-309.

[118] Officers of Tri-Continental Corp. and three open-end funds, Broad Street Investing Corp., National Investors Corp., and Whitehall Fund, Inc., are partners of J. & W. Seligmau & Co., an NYSE firm, and also serve as officers of the companies' wholly-owned—Union Service Corp. See ch. III, pp. 106-108, supra.

[119] Lehman Bros., the NYSE member firm which is the Lehman Corp.'s adviser, also is the adviser to the One William Street Fund, Inc., which is now a no-load fund. See note 119, on p. 52, supra.

heimer Fund, Inc.—also are closely affiliated with NYSE members.[120] Also, as previously indicated, in 1965 and 1966 broker-dealer subsidiaries of the advisers of three of the largest fund complexes and one smaller one became member firms of the Pacific Coast Stock Exchange.[121] The adviser-underwriters to a number of other funds are also members of regional exchanges and of the NASD and thus are in a position to—and sometimes do—receive brokerage commissions directly or indirectly from fund transactions.

Close affiliations between investment companies and broker-dealers who execute their portfolio transactions raise questions similar to some of those raised by the use of brokerage commissions to compensate dealers for the sale of fund shares. For example, such affiliations could possibly lead investment company managers to adopt investment policies that call for high portfolio turnover rates for the purpose of increasing the amount of brokerage commissions obtainable through their relationship with the companies. This potential for abuse led one State—Wisconsin—to prohibit the sale of shares of a mutual fund which was closely affiliated with an exchange member unless the fund's bylaws or articles of incorporation provided that the member could not directly or indirectly profit from fund portfolio transactions.[122]

The Wharton Report examined the relationship between mutual fund portfolio turnover rates and broker-dealer affiliations. Out of 163 mutual fund advisers surveyed in 1960, the controlling management group of advisers to 26 funds were closely affiliated with brokers.[123] The Wharton Report found that such brokers tended to do a large part of the funds' brokerage business,[124] but there was no close relationship between broker affiliation and fund turnover rates.[125]

The Commission's staff reached similar conclusions when it studied portfolio turnover rates of 109 funds.[126] The 1964 median turnover rate of these 109 funds was 20.3 percent. Out of 14 of these funds which may be considered "closely affiliated" with a broker-dealer, 8, or over half, had turnover rates below the median for all 109 funds.

Close affiliations between broker-dealers and investment companies also raise questions relating to the fulfillment of the investment company managers' duty to seek the best execution of portfolio transactions. If its affiliated broker-dealer is an exchange member, the manager of an investment company may be less inclined to consider opportunities for best execution in the third market where the affiliated broker could not earn an exchange commission. However,

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120 In most cases an adviser which is also an NYSE member receives both an advisory fee and brokerage.

121 See pp. 172-173, supra, and ch. III, pp. 109-110, supra.

122 Wisconsin Department of Securities, monthly bulletin May 1958, 3 CCH Blue Sky L. Rept. 52,623.03, interpreting Wis. Stat. Ann. ch. 189, sec. 13, 3 CCH Blue Sky L. Rept. 52,113.

Until December 1963, Illinois also prohibited the sale within that State of the shares of funds which gave brokerage business to brokers affiliated with the funds' advisers. (See 1 CCH Blue Sky L. Rept. 16,785.)

123 The Wharton Report considered close affiliations as those involving the adviser itself, its parent or subsidiary, or an organization majority owned by members of the controlling management group, as distinguished from those affiliations based only on interlocking personnel, looser financial relationships and minor ownership interests. Wharton Report 473-474.

124 Wharton Report 32, 473-75.

125 Although the combined turnover rate for closely affiliated funds was higher than the comparable rate for the industry in every year from 1953 to 1958 the disparity between the rates decreased markedly over the period. The higher rate of the affiliated fund; was explained, for the most part, by their relatively smaller size. Of 25 such closely affiliated funds for which the Wharton Report presented data, 13 had less than $10 million in assets on Sept. 30, 1958. These smaller affiliated funds had turnover rates which were roughly comparable to those of non-broker-affiliated funds of the same size. Turnover rates of the largest broker-affiliated funds were lower than those of the comparable industry group in all 6 years. Wharton Report 225.

126 This sample was taken from the 150 funds which had filed a Form N-1R with the Commission by Oct. 25, 1965. Of the 150 funds, 41 were eliminated because they were exchange funds, funds with less than $1 million in assets or funds which failed to answer properly item 1.25 of Form N-1R relating to portfolio turnover rates. For a further discussion of portfolio turnover rates in terms of fund size, see ch. VI, pp. 245-255, infra.

neither exchange membership nor affiliation with exchange members diminishes the fiduciary obligation of investment company managers to seek the best execution—a fiduciary obligation imposed by basic concepts of trust and agency law.

Analogous problems may arise when a closely affiliated broker-dealer acts for an investment company in the over-the-counter market. Since investment companies normally do not need a broker-dealer intermediary for these transactions and since over-the-counter commissions and markups are subject to negotiation, close affiliation between a broker-dealer and an investment company may lead to unnecessary use of a broker-dealer intermediary and to commissions or markups higher than those paid by investors who are in an arm's-length relationship with their brokers.

The Act deals with these problems by placing some limitations on the type and amount of compensation that broker-dealers may obtain from executing portfolio transactions for their affiliated companies.[127] In addition, and even more important, are the basic fiduciary standards incorporated in the Act which govern relationships between investment companies and affiliated broker-dealers.

The ever-present potential for abuse inherent in investment company-broker relationships requires close watch. However, the Commission at this time does not recommend legislation precluding or limiting broker-dealer affiliations in the investment company industry. The Commission's conclusion rests significantly upon its recommendation that an express and readily enforceable statutory standard of reasonableness be applicable to all managerial compensation received by affiliated persons of investment companies. Under that standard, brokerage commissions paid to affiliated broker-dealers would be a factor in the consideration of the reasonableness of the total compensation and benefits that investment company managers receive by virtue of their relationships to investment companies.[128] If Congress accepts this recommendation, affiliations between investment companies and broker-dealers should in the future produce significant benefits to investment companies and their public shareholders in the form of reduced management costs.

E. CAPITAL GAINS DISTRIBUTIONS

1. *Investment company practices*

Almost all investment companies regularly distribute all or a substantial portion of their realized long-term capital gains to their shareholders. Although most distribute them on an annual basis, some do so semiannually and others quarterly.[129]

Until 1956, the distribution of realized capital gains was necessary to obtain the benefits of the "flow-through" treatment afforded investment companies under the Internal Revenue Code. Since that time investment companies have bean able either to distribute or retain such gains without losing those benefits. If the gains are distributed, they are taxed as capital gains to shareholders[130] and

[127] Act, secs. 10(f), 17(a), and 17(e); see ch. II at p. 71, supra.
[128] See ch. III, p. 145, supra.
[129] A survey of the responses to item 1.29 in the Form N-1R's filed by 325 funds for 1965 disclosed that 44 investment companies distributed capital gains more often than annually; 27 on a semi-annual basis, and 17 on a quarterly basis.
[130] Code, sec. 852(b)(3)(B).

not to the company.[131] If they are retained, the company must pay a 25 percent capital gains tax,[132] but shareholders can report the gains on their individual tax returns, take a 25 percent tax credit for the payments made by the fund, and step up the cost of their investments for tax purposes by 75 percent of the realized gains.[133] Thus, the investment company shareholder is in almost the same position with respect to his Federal income tax whether the gains are retained or distributed.[134] Nevertheless, with the exception of certain exchange funds and some closed-end investment companies, investment companies generally distribute their net realized long-term capital gains.

The practice reflects, in part, management's judgment as to the adverse reaction of existing and potential shareholders if capital gains distributions were discontinued. Although realized capital gains are not earned income or a return on an investment in the same sense as dividends, investment company managers have found that a decrease in the size of a capital gains distribution tends to elicit angry letters from shareholders complaining about the "cut in the dividend." Some of these letters compare the fund unfavorably with industrial companies whose dividends have not been cut. Such letters indicate either that shareholders do not understand the distinction between the distribution to them of their own capital and the distribution of earned income on such capital or that, if mindful of the distinction, they desire to receive such distributions.

The shareholders' attitudes may be mirrored by the dealers who sell fund shares. They find it easier to sell shares if a sizable amount of capital gains is regularly distributed and add their complaints to those of the shareholders when the amount of the capital gains distribution is reduced. Some fund managers have stated that dealers frequently urge them to increase the size of capital gains distributions in order to make the fund's shares more attractive for sales purposes.

The dealers' reactions may reflect the fact that income dividends distributed by mutual funds in recent years have tended to be relatively low in relation to their asset value. During the period, 1956–65, the average dividend distribution for most of the mutual fund sector of the investment company industry ranged from 3.63 percent of average net asset value in 1957 to 2.48 percent of average net asset value in 1965.[135] This reflects high advisory fees paid by mutual funds as well as their tendency to concentrate their portfolios in common stocks, on which yields in recent years have been generally lower than the interest rates paid on bonds or on deposits in savings institutions.[136] However, the size of the funds' income dividend distributions tend to be obscured if viewed in connection with their capital gains distributions, which ranged during the period 1956–65 from 3.47 percent of average net asset value in 1956 to 2.03 percent of average net asset value in 1963.

2. Effect on selling practices and portfolio management

Frequent distributions of capital gains could facilitate "selling dividends," an improper selling practice which consists of encouraging

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131 Code sec. 852(b)(3)(A).
132 Code: sec. 852(b)(3) (A).
133 Code sec. 852(b)(D)(ii) and (iii).
134 See ch. 11, appendix pages 80–82, supra, for a discussion of the tax consequences to investment company shareholders of the companies' capital gain distributions.
135 Source: Investment Coinpany Institute.
136 Of course, savings deposits provide no opportunity—and debt securities provide little opportunity—for capital gams.

a prospective investor to purchase fund shares after a distribution has been announced but before the "ex-distribution" or record date.[137]

The investor is led to believe that he will benefit from the impending distribution. In fact a purchase of mutual fund shares shortly before a record date is most likely to be harmful to him. Since the full amount of the distribution is included in the net asset value which he will pay for his shares, an investor who purchases shares prior to the record date of the distribution will (1) lose the portion of the sales load he paid that is attributable to the amount of the distribution and (2) pay an ordinary income tax on the regular income portion of the distribution and a capital gains tax on the capital gains portion, even though both of these constitute an immediate partial refund to him of the money that he has just invested.

Emphasis on the realization of capital gains harms investment performance and frustrates attainment of investment objectives. Appreciated stock may be sold in order to realize capital gains even though it otherwise would be retained, while depreciated stock may be retained solely to avoid realizing a loss which would reduce the net capital gains available for distribution.

In one instance of this sort[138] the fund's prospectus represented that its principal and primary objective was capital growth and that such an objective would result in a normal turnover of portfolio securities. The Commission found, however, that the fund's primary objective was to provide cash flow to its stockholders at a high and uniform rate in the form of quarterly distributions made up principally of capital gains.[139] To accomplish this objective, the fund:

> * * * followed the practice of selling securities for the primary purpose of realizing a uniform and predetermined amount to be distributed as capital gains and without consideration of whether the growth potential of a given investment had been fully achieved * * *.[140]

The Commission also found that the management of the fund had chosen to realize gains in order to distribute them "without considering whether proper management of the portfolio would have required the sale of securities in which net unrealized depreciation existed, which would have reduced the gains available for distribution." [141] The policy followed by the fund resulted in a high rate of portfolio turnover. The Commission concluded that the fund managers had adopted this policy to promote fund share sales, thereby increasing their sales commissions and advisory fees.[142]

Another case uncovered by the Commission's staff involved a fund whose prospectus described its objectives as "reasonable income'' and "long-term capital growth." However, new management had adopted a policy of realizing enough capital gains to bring quarterly fund distributions of income and capital gains up to an effective level of approximately 6 percent of the fund's offering price. That policy was not

137 Shareholders of record on that date receive the distributions.

138 *Managed Funds*, Inc., 39 S.E.C. 313 (1959).

139 In the fiscal years 1956 1967 and 1958, Managed Funds had 12-equal quarterly distributions of capital gains for each of two of the 'seven' classes of shares it issued. There was also a high degree of uniformity in the amounts distributed on the other five classes. 39 *S.E.C.* at 321.

140 39 S.E.C. at 321–22. In many instances, quarterly distributions were authorized during the year which exceeded the gains already realized so that the fund was under pressure to sell additional securities in an attempt to realize the amounts needed for the distributions.

141 39 S.E.C. at 321. In many instances, the securities were reacquired immediately thereafter at some what higher prices than those at which they had been sold.

142 39 S.E.C. at 323.

disclosed in the prospectus, but it was set forth in an internal memorandum which stated that the "fund's objective is to pay out 6 percent: 3 percent income and 3 percent capital gains." Other internal memoranda showed the effect of this policy on the fund's investment decisions: [143]

> Memorandum dated July 30, 1958: "Yesterday he (an official of the fund's manager) called me to say that the committee had become very apprehensive about the level of the stock market and accordingly had decided to establish enough profits to meet their capital gains distribution requirements for the remainder of the year * * *."
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> Memorandum dated January 27, 1959: "Capital gains for 1959—may be established as needed. Sell holdings which will not be added to and sell and repurchase holdings which continue to be attractive * * *."

The minutes of a meeting of the executive committee for the fund held on November 24, 1958, contained the following statement:

> It was the consensus of opinion that, due to the increasing volume of institutional and public buying of equities and the increasing scarcity of stock available for purchase, expectable yields will tend to diminish, thus requiring larger capital gains distributions in the future if we are to maintain an overall payout of 6 percent on per share offering price.

A representative of the investment counseling firm which acted as a subadviser to the fund testified during an investigation that an official of the adviser told him that the fund "should have capital gains distributions of approximately 3 percent per annum." The employee also testified as follows:

> Q. Did Mr. ——— say to you that he intended to recommend the sale of securities only to realize capital gains without relation to the principles of prudent investing?
>
> A. He didn't put it in those words.
>
> Q. Did he say that he intended to sell securities just to realize capital gains for the sake of distribution?
>
> A. That was the intent.[144]

3. *The adequacy of existing regulation*

Concern over the effects of capital gains distributions on fund selling practices and portfolio management has led the Commission, State securities administrators and industry organizations to take certain steps to mitigate abuses. For example, the Commission required that investment company prospectuses and dividend notices make clear the distinction between capital gains distributions and dividends.[145] Moreover, the Commission's statement of policy with

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[143] The memoranda from which these quotations are taken were drafted before publication of the *Managed Funds* decision. After that decision no further memoranda on the subject were prepared.

[144] This situation was remedied through private administrative proceedings.

[145] This represents an effort to implement the policy expressed in sec. 19 of the Act. which provides that:

"It shall be unlawful for any registered investment wmpany to pay any dividend, or to make any distributioqm the nature of a dividend payment, wholly or partly from any source other than—

(1) such company's, accumulated undistributed net income, determined in accordance with, good accounting practice *and not including profits* or *losses realized upon the sale of securities* or *other properties;* or

"(2) such company's net income so determined for the current or preceding fiscal year;

unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment. The Commission may prescribe the form of such statement by rules and regulations in the public interest and for the protection of investors." [Emphasis added.]

See also rule 19-1 under the Investment Company Act (17 C.F.R. sec. 270.19-1).

respect to investment company advertising and sales literature, developed in conjunction with the NASD, states that it is "materially misleading * * * to combine into any one amount distributions from net investment income and from any other source." The statement of policy also requires that its members present capital gains distributions separately from ordinary dividend distributions and avoid any implication that capital gains distributions represent part of a regular return on an investment in investment company shares.[146]

NASA also has sought to deal with the problems posed by capital gains distribution practices. In 1952 it adopted resolutions which (1) oppose any announcement by an investment company of a declaration of, or an intent to declare, an income or capital gains distribution more than 15 days prior to the ex-distribution date, (2) require that the ex-distribution date for the final distribution for the fiscal year shall not be prior to the 15th day of the month preceding the last month of the fiscal year, and (3) place limitations on the descriptions and advertising that can be used with respect to accumulated undistributed income and distributed and undistributed capital gains. These resolutions, however, are not binding on members.

Although these regulatory controls have discouraged the practice of "selling the dividend," investment company managers are still subject to pressures to maintain regular and significant capital gains distributions. Despite emphasis on adequate disclosure, some shareholders apparently do not appreciate the disadvantages of receiving such distributions on a regular basis—the untimely or unnecessary payment of capital gains taxes, the payment of a sales load on a part of their investment which shortly thereafter is returned to them, and the possible adverse effects on portfolio management of undue stress on the regular realization of capital gains.[147]

Of course, one way to insulate the funds from the pressure to realize capital gains for distributions and to prevent the sale of fund shares on the basis of capital gains distributions would be to prohibit the distribution of long-term capital gains. However, if this were done, the substantial number of investors who do not take their capital gains distributions in fund shares would lose what they may have come to rely upon as a significant source of cash or would be put to the inconvenience of redeeming some of their shares.

The Commission does not believe that investment companies should be required to terminate capital gains distributions irrespective of their shareholders' wishes. However, in the Commission's view, there is no justification for distributing capital gains more often than once a year. Such a limitation has been endorsed by the Investment Company Institute. Among other things, its "Guide to Business Standards" specifically states that distributions of capital gains other than at fiscal year ends or soon thereafter could imply that capital gains distributions are part of regular dividends from investment income. However, not all mutual funds belong to the Institute; nor is its Guide binding on its members. The Commission, therefore, recommends that this limitation be extended to all investment companies by an amendment to the Act. The incorporation into the statute of

[146] NASD Manual J-4, 5, 42, 43.

[147] The harm to investors of untimely sales of portfolio securities in response to these pressures is compounded by the payment of unnecessary brokerage commissions by the fund on such sales and on the subsequent reinvestment by the fund of the proceeds. In 1965 some 80 percent of all capital gains distributions by ICI member funds were taken by their shareholders in fund shares.

this prohibition would relieve managers from pressure to realize such gains on a frequent and regular basis, mitigate improper sales practices related to the distribution of such gains, and eliminate the administrative expenses attending quarterly or semi-annual capital gains distributions.

F. INSIDER TRANSACTIONS INVOLVING INVESTMENT COMPANY PORTFOLIO SECURITIES

1. The problem of insider trading

Purchases and sales of securities by persons associated with investment companies on the basis of their knowledge of the company's projected portfolio transactions are a recognized area of concern in the investment company industry.[148] An investment company's acquisition or disposition of a large position in a particular security over a relatively short period of time tends to have an impact upon the market in that security. Consequently, persons having prior knowledge of such a transaction are in a position to profit by acting in advance of the company. While the extent to which such insider transactions may adversely affect the price to the company depends upon a number of factors, the possibility of interference with and harm to the company is present. An investment company may also be harmed if an insider induces the company to purchase or hold portfolio securities in order to protect or strengthen his own investment in these securities.[149]

Whether or not an insider's purchase or sale of a security on the basis of inside information as to his company's investment program actually harms the company, such a transaction creates an "ever present danger of a conflict of interests."[150] The conflict is analogous to that involved if an investment adviser who buys or sells a security for his own account thereafter recommends to his investment advisory clients a course of action with respect to that security from which he personally profits. The Supreme Court has held that such conduct by an investment adviser is fraudulent even without proof of an intent to harm or of actual harm to his clients.[151]

The Special Study's survey of securities transactions by persons and companies affiliated with a mutual fund or a mutual fund advisory organization produced evidence that as many as **14.4** percent of all such persons and companies included in the survey had traded in portfolio securities of the fund with which they were associated during the same period as the fund. Eight percent had traded within **15** days prior to the fund's trading. Trading following transactions of the investment company was reported by **20.7** percent of all persons and companies surveyed.[152]

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148 See Special Study, pt. 4, 255.

149 See *S.E.C.* v. *Midwest Technical Development Corporation,* CCH Fed. Sec. L. Rep. ¶ 91,252 (U.S.D.C. Minn. 4th Div., 1,963).

150 *S.E.C.* v. *Midwest Technical Development Corporation, supra,* CCH Fed. Sec. L. Rep. at ¶94, 146; see also Special Study, pt. 4, p. 237

151 *S.E.C.* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963). *Cf. S.E.C.* v. *Texas Gulf Sulphur Compuny,* —F. Supp.— (S.D.N.Y., No. 65 Civ. 1182, August 19,1966) and *Cady Roberts & Co., Inc.,* 40 S.E.C. 907 (1961).

152 Special Study, pt. 4, p. 241.

2. Industry codes and guidelines

(a) Types

The Special Study found insider trading in investment company portfolio securities to be widespread despite industry awareness of the ethical problems raised by this practice.[153] Many funds and their investment advisers had policies, written or unwritten, aimed at these problems.[154] However, both the policies themselves and the manner in which they were enforced varied widely. Only 10 of the 38 policies reviewed had procedures established to implement them and only 16 were found to be well articulated. The Special Study stated that "the vagueness of some of these policies and the variety of others * * * suggest considerable disagreement in the industry as to the nature and extent of obligations in the area.",[155]

The Special Study also noted that in January 1962 the Investment Company Institute adopted a Guide to Business Standards which, among other things, exhorted all officers, directors and employees of member investment companies and their advisers with knowledge of an investment decision by the company to refrain from taking any action "inconsistent with such person's obligations to the investment company." [156] The Special Study considered this policy vague and pointed out that the Investment Company Institute had no power to enforce its Guide.[157]

The Special Study concluded that all companies, their investment advisers and principal underwriters should have written policies, as concrete and specific as possible, prohibiting their officers, directors, employees, partners, and certain stockholders from engaging in insider trading both while the company was actually buying or selling and for a period preceding and following such a program by the company. The Special Study excluded from its recommendation unaffiliated directors without knowledge of company action or intentions. On the other hand, it concluded that any person who had recommended the purchase or sale of a security by a company should be required to delay any transaction on his own part until the company had followed the recommendation or had rejected it.[158] In addition, the Special Study recommended that every person covered by a company policy as to insider trading should be required to report to the company his transactions in portfolio securities and that violations of the company's policy should be subject to appropriate sanctions and reported to the Commission.[159]

Subsequent to the publication of the Special Study the Commission's staff surveyed the responses to items pertaining to codes of ethics in the annual reports filed with the Commission on Form N-1R

[153] Special Study, pt. 4, p. 250.
[154] Special Study pt. 4, pp. 249–254.
[155] Special Study: pt. 4, p. 252.
[156] The Guide provides, in relevant part, as follows:

"1. Private dealings:

"When the appropriate persons have determined to purchase or sell a specific security for the portfolio of a member investment company or companies, or have such action under immediate consideration, no officer, director, or employee of the investment company or companies or of the investment adviser who knows of such determination or consideration should take any action in connection therewith which is inconsistent with such person's obligations to the investment company or companies, giving recognition, however, to any other fiduciary responsibility imposed upon such person. Management should take adequate steps to insure that this policy is made known to the personnel affected."

See p. 199, infra, for a recent development in the Investment Company Institute's approach to this problem.

[157] Special Study, pt. 4, p. 251.
[158] Special Study, pt. 4, pp. 253–254.
[159] Special Study, pt. 4, p. 255.

by some 255 investment companies (182 open-end and 73 closed-end companies).[160] Out of the 255 companies surveyed, only 74, 29 percent, indicated that they had adopted a formal written code or policy with respect to trading in portfolio securities by their officers, directors, employees, and advisory board members.[161] One hundred and six companies, 41 percent, failed to indicate the adoption of any code or policy of any kind on these matters. The remaining 75 companies, 30 percent, had either adopted an informal, unwritten code or policy or stated that they adhered to the one set forth in the ICI Guide to Business Standards.

The 255 investment companies were managed by 192 separate investment advisory organizations. Eighty-four of these advisory organizaiions, 44 percent, had adopted codes or policies regarding insider trading in investment company securities. No policy of any kind was indicated for 44 of the 192 investment advisers—23 percent. The remaining 64 advisers, 33 percent, had either adopted informal, unwritten policies or stated that they had adopted the policy set forth in the ICI Guide for their officers, directors, and employees.

As was the case at the time of the Special Study, the provisions of the codes and policies reported in the Form N–1R vary widely. For example, one code of ethics prohibits officers, directors, and employees of both the mutual fund and its investment adviser from conducting transactions for themselves or members of their families until 2 weeks after the security has appeared on the fund's buy or sell list. These people are also prohibited from making any purchase or sale of a security in anticipation of its being approved for purchase or sale by the fund and from accepting any favors from a broker which might put them or the firm under obligation to the broker.[162]

Another fund's investment adviser requires, pursuant to a written code, that all its officers and employees and members of their immediate families purchase and sell securities solely through an affiliated broker. Investment officers working on a security on behalf of the fund must defer their personal transactions until the fund has decided to take no action or has completed its own program. However, research personnel working on a particular security may buy or sell that security so long as the fund is not currently engaged in a buy or sell program in that security, but they must receive approval from a senior officer of both the fund and the investment adviser before buying or selling any security. In contrast, a policy contained in another fund's articles of incorporation restricts the fund from acquiring or holding securities of which the fund's officers, directors, or employees hold a "material" amount. The fund's investment adviser has no written or informal policy on trading in securities.

Many of the formal and informal codes and policies adopted by investment companies and their advisers appeared too weak, too

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[160] Item 1.33(a) of Form N–1R requires the company to state whether it has a code of ethics or other policy, written or informal, with respect to trading in securities (other than securities of the company) by its officers, directors, or employees, or members of any advisory board or advisory committee of the company. This item also inquires as to the procedures employed to make known such code or policy to the individuals concerned and whether the company undertakes to implement such code or policy (without disclosing the specific methods employed). A copy of any such written code or policy is required to be filed with the report or incorporated by reference to the last annual report if the policy has not changed. Item 1.33(b) calls for similar information with respect to the company's investment adviser.

[161] Twenty-six of these companies stated that they were subject to the written code of their investment adviser, and one stated it was subject to its adviser's informal code.

[162] In the fund referred to, short selling and dealing in options and commodities are prohibited, and the Personnel are urged not to purchase securities on margin. They are also prohibited from purchasing any new issue of common stoeks or convertible securities until 5 business days after the public offering and then they may purchase them only at the prevailing market price.

vague or otherwise inadequate to furnish sufficient guidance with respect to insider transactions in investment company portfolio securities- Out of 229 codes and policies,[163] the staff considered at least 43 wholly inadequate for this purpose. One internally managed. fund stated that it has no written code but that its officers, directors, and employees generally understand that they are not to take personal advantage of any information they may have concerning the fund's current investment decisions or programs. Another fund without a written policy- stated that transactions by personnel of the principal underwriter in the securities owned by the fund at the time the fund is making such transactions "are not looked on with favor." It further stated that it is the policy of the fund's investment adviser to have any member of the adviser's investment committee disclose fully any interest ha. may have in a security under consideration so that his transactions should not coincide with transactions of the fund.

(b) Implementation

The responses to the Form N-1R indicated that in addition to the substantial number of companies and advisers that lack written codes or policies with respect to insider trading in portfolio securities, only about 48 percent of the investment companies and about 56 percent of the investment advisers which have such codes or policies have adopted procedures for implementing them. The more informal the code or policy the more likely it was that procedures to implement it had not been adopted.[164]

Where implementing procedures had been adopted with respect to insider trading, they varied considerably. They either required (1) that any securities transactions by an individual covered by the code or policy for his personal account have prior approval of an appropriate officer of the registrant or the investment adviser; (2) that individuals covered by the code or policy submit annual, semiannual, or quarterly reports listing all securities held in their personal accounts; or (3) that individuals covered by the code or policy sign a statement—annually, semiannually, or quarterly—that they have not violated that code or policy.[165]

[163] Excludes companies and advisers which indicated that they followed the policy set forth in the Investment Company Institute Guide. The standards are essentially subjective and do not indicate the kind of conduct deemed inconsistent with an insider's obligation to an investment company. The Guide leaves it to the individual officer, director or employee to determine when and under what circumstances he and members of his family will buy or sell portfolio securities.

[164] The number and percentage of investment companies and advisers which indicated the existence of implementation procedures are shown below, on the basis of the type of code or policy adopted.

Type of code or policy	Investment companies[a]			Investment advisers		
	Number	Implementation procedures		Number	Implementation procedures	
		Number	Percent		Number	Percent
Written	74	49	66	84	58	69
Informal	38	13	34	33	16	48
ICI Guide	37	10	27	31	9	29

[a] Includes those subject to codes or policies of their advisers.

[165] As noted at p. 197, supra, certain funds and investment advisers with affiliated brokers require that all officers, employees and members of their families conduct all securities transactions through the affiliated broker. This makes available a complete and current check on all trading by the individuals concerned. In other instances the company stated that it relied on voluntary reports in "questionable cases," or in cases in which the potential purchaser anticipated a "possible effect on the market price."

Of course, the failure to adopt procedures for implementing codes or policies on insider trading or to fix responsibility for such implementation seriously impairs the value of even the most carefully drafted code. For example, an inspection of one large complex conducted by members of the Commission's staff disclosed that, despite a policy that affiliated persons should acquire securities for investment only, the senior officer responsible for directing portfolio transactions had maintained two active personal trading accounts as well as four less active investment accounts. The investment company was presumably unaware of this violation of its policy because it had no procedures for implementing it. A routine inspection of another investment company complex revealed that reports of securities transactions by insiders had not been reviewed by anyone in a position of authority.

3. Conclusions and recommendations

The development of adequate restraints on trading in portfolio securities by officers, directors, and employees of investment companies and of their investment advisers is an unresolved problem in the investment company industry. While persons affiliated with investment companies cannot be expected to refrain from engaging in securities transactions for their personal accounts, the shareholders they serve also are entitled to assurance that such transactions will not conflict with the investment programs of their companies. The absence of effective codes of ethics and policies with respect to insider trading in investment company portfolio securities and of procedures for implementing those codes or policies deprives public shareholders of that assurance.

During the course of preparation of Form N–1R, the Commission suggested to the Investment Company Institute that its members draft a written code of ethics covering insider trading in investment company portfolio securities. Although an institute committee explored the matter extensively, it was unable to agree upon a detailed code which it believed would be appropriate for the varying sizes and structures and methods of operation of its members. Instead, the committee proposed a revision of the Institute's Guide to Business Standards for submission to its members for their consideration and adoption.[166] While the proposed revision of the Institute's Guide expressly recommends the adoption by individual managements of written codes and implementation procedures, it does not set forth guidelines. Moreover, the institute has no enforcement powers, and its membership includes neither the closed-end sector nor all of the mutual fund sector of the investment company industry. Hence there is no assurance that any code or policy it might recommend will be adopted and uniformly adhered to throughout the industry.

The Commission recognizes that the development of adequate restraints on insider trading in investment company portfolio securities is a complex undertaking. Nevertheless, it believes that ade-

[166] The proposed revision would read as follows:

"1. Private dealings:

"Officers, directors, employees, trustees and partners of member investment companies or their adriser should not knowingly engage in securities transactions in a manner inconsistent with such persons' obligations to such member investment companies or designed to profit by the market effect of such member-companies' securities transactions. Management should formulate a written code to carry out these principles in the light of each respective company's manner of operation, should take adequate steps to insure that such code is made known to the personnel affected, and should provide appropriate measures to satisfy itself that the code is being complied with."

quate standards and effective procedures for implementation can and should be developed. However, at present there appears little likelihood of agreement within the industry sufficient for attainment of this objective.

The Commission has authority under the broad antifraud provisions of the Exchange Act and the Investment Advisers Act to adopt rules against insider trading abuses by persons affiliated with investment companies.[167] Should industry consensus with respect to the development of adequate codes of ethics governing insider trading prove to be unattainable or their implementation prove to be inadequate, Commission action will be necessary.

The Commission believes, however, that it would be preferable to deal with problems of insider trading in investment company portfolio securities in a more flexible manner than may be possible under provisions of the Exchange and Investment Advisers Acts or the existing provisions of the Investment Company Act. For example, it may be argued by some that the Commission does not have authority under those provisions to require that companies adopt their own codes of ethics meeting specified minimum standards, even though this is feasible and may be an adequate way of dealing with this problem. To avoid any possible uncertainty the Commission recommends that the Investment Company Act be amended specifically to empower the Commission to adopt rules and regulations for the protection of investors in connection with insider trading in portfolio securities by persons affiliated with investment companies. The adoption of such an amendment would give the Commission adequate power to deal with problems of insider trading in investment company portfolio securities and would represent a Congressional reaffirmation of the need for effective action in this area.

[167] Exchange Act, secs. 10(b) and 15(c); Advisers Act, sec. 206.