Pershing & Co.
New York, NY

March 4, 1968

Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Gentlemen:

This communication is submitted by Pershing & Co. ("Pershing") in opposition to proposed Rule 10b-10 under the Securities Exchange Act of 1934.

Pershing is a member of the New York Stock Exchange and the American Stock Exchange with its own floor representation and clearing facilities. Most of Pershing's business is transacted for correspondent brokers, all of whom are members of the New York Stock Exchange. The correspondent brokers transmit orders to Pershing which handles execution and clearance in return for a share of the commissions. Pershing discourages business from individual investors but it does accept orders from institutions such as banks, insurance companies, charitable foundations and mutual funds. Pershing transacts all of its business with its correspondents, and practically all of its other business, on the basis of a split commission.

Proposed Rule 10b-10 would prohibit Investment company managers from directing brokers to "give-up" any part of their commission on securities transactions to broker-dealers or others unless the amounts given up are returned to the investment company shareholders.

It is well-known that fund managers often use give-ups to compensate brokers for non-selling services such as investment Information, ideas, pricing of fund portfolios and other non-sales services. It is equally well-known that managers of funds who do not sell their shares at retail exclusively through a "captive" sales force often direct give-ups in favor of dealers who sell shares of the fund thereby, in effect, furnishing those dealers with additional compensation for such sales.

We firmly believe that elimination of these give-ups would be inconsistent with established business practices, ineffectual to advance the public interest and inimical to regional securities firms. We refer to the following:

1. Give-ups are an established business practice and reciprocity is an accepted business custom. The securities industry is no exception. Within the primary requirement of seeking the best execution of portfolio transactions, mutual fund managers naturally seek to compensate broker-dealers who provide something of value to the fund. This is good, standard business practice.

2. While give-ups may result in increasing the underwriting and advisory income of fund managers, more importantly they substantially benefit the fund and its shareholders. Give-ups allocated for non-sales services plainly accrue to the benefit of the fund. Moreover, those allocated for sales of fund shares benefit the fund and its shareholders because (a) the sales provide liquidity which is important to redeemability of fund shares and successful portfolio management, (b) as the fund grows in size, the managers have broader and better investment opportunities, and (c) as the fund grows there are economies of operation attributable to the larger size, and the shareholders benefit therefrom, in the many cases where there is a declining scale of management fees.

3. We all recognize that fund managers have the fiduciary obligation to seek the best price and execution. Present give-up practices permit fund managers to entrust their portfolio transactions to a selected broker or brokers on whom the managers rely for best execution and yet to compensate various other brokers for sales of fund shares or other services. Fund managers can seek the most qualified broker, the best service and the most prompt professional assistance for execution and decide at that time, or at a later date, the allocation of give-ups. Experience has indicated that an effective way of handling large orders is through the "lead" broker. Change of this practice could be adverse to best execution by creating fragmentation or dispersal of orders based on reciprocity or similar considerations other than best execution.

4. Elimination of give-ups thereby eliminating use of brokerage commissions for research and other non-sales services would have a proportionately greater adverse competitive effect on small funds than on large funds which have their own-substantial advisory organizations.

5. Give-ups help compensate dealers who serve the public purpose by bringing to the small investor the opportunity for equity investments and professional management through mutual funds. Sales of mutual fund shares require considerable personalized and intensive selling effort including search for prospective investors, meetings and otherwise. The small funds necessarily depend upon independent local dealers to sell at retail to the public. Larger funds often have other outlets, in whole or in part, whether by way of "captive" sales forces, direct mail or otherwise. We believe that elimination of give-ups and lessening of sales incentive to local dealers would be particularly disadvantageous to small funds.

6. Abolition of customer-directed give-ups would have a serious adverse effect on the securities industry and particularly the regional firms. The effect would vary greatly among different firms. We are informed that many firms, particularly regional ones, depend upon give-ups directed by fund managers for a substantial part of their net income and in some cases, particularly in the smaller firms, perhaps even the difference between profitable and unprofitable operation. We believe that elimination of such give-ups might materially impair the financial strength find servicing abilities of certain securities firms, particularly regional ones, with consequent adverse effect to those firms and the local investing public.

We are aware of the contention sometimes made that give-ups create pressure for "churning" of portfolio transactions to generate brokerage commissions. However, we are not aware of any substantial' evidence that "churning" actually results from give-up practices. "Churning" is a serious fraudulent practice and the penalties imposed by law presumably act as a deterrent. Additionally, the portion of the brokerage commission which is not given up (but is retained by the "lead" broker) acts as a further deterrent to "churning". Moreover, any temptation towards "churning" because of give-ups seems to be lesser than the temptation which may exist in cases where commissions are paid by fund managers to brokerage firms with which they are affiliated by ownership or otherwise. Yet in the latter cases, no apparent relationship is known to exist between broker affiliation and activity of portfolio transactions, although the fund managers benefit from the commissions paid to the affiliated brokerage firms.

While we oppose proposed Rule 10b-10 in its entirety, nevertheless we urge that, in any event, there should be appropriate exceptions to the proposed Rule. Thus, we urge a specific exception as follows: Proposed Rule 10b-10 does not intend to disturb the traditional relationship between correspondent brokers by which commissions are shared between the broker transmitting the order and the broker executing the order on the New York Stock Exchange. In such case the executing broker acts as the agent for the transmitting broker. Thus, if a fund gives an order to an out-of-town broker with which it has a regular brokerage relationship and that broker transmits the order for execution to a New York firm with which it has a regular correspondent relationship, Rule 10b-10 does not preclude the two brokerage firms dividing commissions between themselves according to their own arrangements (and relevant rules of the Exchange). Nevertheless, if the same fund gives a particular order directly to the New York executing firm, Rule 10b-10 would invalidate directions of the fund managers to remit a portion of the commission to the out-of-town broker with which the fund has a regular brokerage relationship. We urge that remission of a portion of the commission should be permitted, upon instructions of the fund, to a broker who has a bona fide brokerage relationship to the fund and an existing correspondent relationship with the executing broker. This would be consistent with principles of agency and the duties between themselves of the transmitting broker as the regular principal and the executing firm as the regular agent.

The New York Stock Exchange has submitted proposals (dated January 2, 1968) for changes in its commission rate structure. As the specific details thereof have not yet been developed, we are deferring comment at this time. In general, it is our position that any revision of the exchange commission rate structure and level should be consistent with preserving and strengthening the auction marker of the New York Stock Exchange which is the keystone of the securities market. We favor commission rate schedules and exchange rules which keep business in listed securities on the exchanges and avoid the dissipation and disintegration of the central auction market.

We requested our attorneys to review the technical aspects of proposed Rule 10b-10 and their comments to us are attached and submitted as a part of this communication.

Very truly yours,

Pershing & Co.

By: [signature illegible]

ABRAHAM L. BIENSTOCK
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New York, NY

February 28, 1968

Pershing & Co.
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Gentlemen:

You have requested our comments on the technical aspects of proposed Rule 10b-10 under the Securities Exchange Act of 1934. We disagree with certain premises of the Commission relating to the proposed Rule.

Proposed Rule 10b-10 would prohibit investment company managers from directing brokers to give-up any part of their commission on securities transactions to broker-dealers or others unless the amounts given up are returned to the investment company shareholders. [Footnote: A "give-up" is defined by the SEC as a "payment by the executing broker to other broker-dealers of a part of the minimum commission he is required to charge his customers". SEC Release No 34-8239 dated January 26, 1968.]

According to SEC Release No. 34-8239 dated January 26, 1968, the "reasoning on which the proposed Rule is based is that, if, as pointed out above [i.e., by the Commission in said Release No. 34-8239], a mutual fund manager has various means at his disposal to recapture for the benefit of the fund, a portion of the commissions paid by the fund, he is under a fiduciary duty to do so". This possibility of recapture may exist under the rules of certain regional stock exchanges. However, in the light of present commission rates and present rules restricting give-ups only to New York Stock Exchange members, we question whether recapture can be effected as to commissions generated on the New York Stock Exchange (at least where the executing broker is not a member of any regional exchange). Particularly as to executions by your firm, which is not a member of any regional exchange, it seems to us that the funds can derive no similar benefit from their brokerage as is derived by dealer-members of the New York Stock Exchange through customer directed give-ups.

But, even assuming existence of the possibility of recapture for the fund itself, it is submitted that the existence of a fiduciary duty would not itself dictate enactment of proposed Rule 10b-10. Under the law applicable to fiduciaries, conflicts of interest or the exercise of fiduciary duties can be waived by the beneficiaries unless there is a compelling public policy to the contrary. There is no absolute rule against conflicts of interest, or requiring the exercise of all fiduciary duties, in the case of a fund manager or other fiduciary who fully discloses all the facts and circumstances to the shareholders or other beneficiaries who acquiesce in the conduct. [Footnote: For example, mutual funds typically receive investment advice and management services from separate organizations which are owned and controlled by officers of the fund. The Investment Company Act expressly recognizes this structure and the Commission "does not propose to disturb it even though it has been recognized for many years that this structure involves a conflict of interest between mutual fund managers and shareholders". (See letter of Manuel F. Cohen transmitting the Mutual Fund Report at P. VIII)]

Proposed Rule 10b-10 should be contrasted with the manner in which the Commission deals with the analogous situation of commission payments by fund managers to brokerage firms with which the fund managers are affiliated by ownership or otherwise. The Commission does not propose to preclude broker-dealer affiliations by fund managers although, in that case, conflict of interest and fiduciary duty may be plainer than in the case of give-ups. In the case of broker-dealer affiliations by fund managers the Commission rests upon the existing provisions of law, including disclosure, plus a proposed amendment to Section 15 of the Investment Company Act which would have the effect of statutorily making brokerage commissions paid to affiliated broker-dealers a factor in the consideration of the reasonableness of the total compensation and benefits that investment company managers receive by virtue of their relationship to the investment company. We do not regard that there is any valid, legal reason requiring a different treatment of give-ups.

SEC Release No. 34-8239 states as to give-ups:

"... diversion of such commissions to benefit an investment company manager may be viewed as additional compensation to the manager for handling the portfolio transactions of the fund within the meaning of, and in violation of, Section 17(e)(1) of the Investment Company Act."

The SEC Release further states (in a footnote):

"The Commission does not believe that investment company directors may properly view the benefits derived by fund managers from give-ups as simply an additional form of compensation for investment management. Not only may this run afoul of Section 17(e)(1) of the Investment Company Act but the benefits derived by investment company managers from this source cannot be precisely or adequately disclosed in the prospectus, or in the investment advisory contract, as is required by Section 15(a)(1) of the Investment Company Act."

We disagree with the position of the Commission that any benefits derived by fund managers from give-ups may not properly be viewed simply as an additional form of compensation for investment management. [Footnote: Compare' Mutual Fund Report, p. 16, where it is stated: "Under existing commission rate structures, mutual fund shareholders could derive greater benefits from their brokerage commissions if the give-up portions of the commissions were transmitted to the funds themselves or their adviser-underwriters for the purpose of reducing management costs. However, in the face of competitive pressures managers of the dealer-distributed funds have not used brokerage, for this purpose."]

It seems to us that management fees that now prevail in the mutual fund industry are determined on the assumption that part of the brokerage from fund transactions will be available to assist in providing sales and non-sales services. We also question whether, as suggested as a possibility by the Commission, give-ups may "run afoul" of Section 17(e)(1) of the Investment Company Act, particularly when it is borne in mind that give-ups have been an established and accepted practice despite the provisions of Section 17(e)(1). However, if that possibility exists, then it could be made clear by Commission exemption or rule or by statute that the established practice of give-ups does not violate, or may continue, despite Section 17(e)(1). Nor do we agree that give-ups "cannot be precisely or adequately disclosed. [Footnote: For example, disclosure might be made in an amended prospectus along the following lines:

"The Company managers will receive substantial benefits, directly or indirectly, from their right to direct brokers who execute portfolio transactions for the Company to "give-up", at the direction of the Company managers, a substantial part of their commissions to other broker-dealers selected by the Company managers. During the period ----- to ----- the aggregate commissions paid by the Company to brokers executing portfolio transactions for the Company was $-----. During the same period, $ ----- thereof or ----- % was given up at the direction of Company managers to compensate brokers who furnish investment information, statistical and other non-sales services while $ ----- thereof or ----- % was given up at the direction of Company managers to brokers to furnish them additional compensation for sale of fund shares. However, there is no understanding with any brokerage firm as to the allocation of such commissions and accordingly, such allocation may vary from time to time."]

We submit:

(1) There is no compelling legal reason to prohibit give-ups at the direction of fund managers to broker-dealers; and

(2) Give-ups can be dealt with in the traditional way of requiring disclosure; and

(3) There might be an express provision of law (perhaps incorporated in the amendment proposed by the Commission to Section 15 of the Investment Company Law subjecting managerial compensation to an express statutory standard of reasonableness) to the effect that the benefits that investment company managers may receive directly or indirectly from give-ups should be taken into account, in determining the reasonableness of managerial compensation received by persons affiliated with investment companies.

In our opinion the foregoing treatment would be consistent with legal principles applicable to mutual funds and would harmonize the treatment of give-ups with the proposed treatment by the Commission of the related situation of close affiliations between investment companies and broker-dealers who execute their portfolio transactions.

Very truly yours,

Abraham I. Bienstock