

Files

MAY 24 1971

M E M O R A N D U M

144-8

TO: Allan S. Mostoff, Associate Director
Division of Corporate Regulation

FROM: Alfred J. Trifiro, Chief ^{agt}
Branch of Inspections and Investigations

SUBJECT: Books and Records Required to be Maintained by "Mutual
Fund" Dealers Pursuant to Rule 17a-3 of the 1934 Act.

RE: Memorandum dated May 11, 1971 to all Regional Offices from
the Division of Trading and Markets and the Chief
Accountant's Office containing guidelines for broker-
dealer inspectors

In accordance with your instructions, I have reviewed the memorandum and attached material which was recently sent to the Regional Offices discussing broker-dealer accounting procedures with respect to transactions in shares of mutual funds. The attachment contains instructional guide-lines for use by Regional Office broker-dealer inspectors. It is suggested that the instructions, in at least the area of plan account transactions (Page 3, Item b --"Application Way Method"), be somewhat modified.

The instructions appear to indicate that customer purchases of mutual fund shares pursuant to any of the various plans for the accumulation of such shares need not be reflected as gross revenue on broker-dealer general ledger records but that the general ledger need only reflect that portion of the transactions representing their income or concession. Such treatment of this increasingly popular type of transaction results in an inaccurate portrayal of what actually transpires.

In a typical voluntary plan for the accumulation of mutual fund shares the retailing broker-dealer acts as principal and for its own account in the initial transaction as well as in all subsequent transactions. This is usually spelled out very distinctly in the application and/or the dealer agreement. Both the investor and the dealer, through the application form, name as their respective agent, a service agent (bank, etc.) to act on their behalf in processing all transactions made pursuant to the plan. The same agent performs functions for the principal underwriter and the mutual fund. As agent for the dealer, the service agent receives transaction orders accompanied by payment directly from investors, processes each transaction, confirms to the investor, and maintains dealer concession records. Similar functions are performed for the principal underwriter. In effect, the shares are purchased by the investor from the broker-dealer at the public offering price; the broker-dealer, as principal and for its own account, purchases the shares from the principal underwriter at the wholesale price; and the principal underwriter purchases the shares from the fund at net asset value. The fact that uncertificated shares are usually involved and that the process is usually highly computerized should not serve to cause the broker-dealers' records to fail to reflect the true nature of such transactions.

Even if in summary form after the broker-dealers receive monthly statements of activity from the service agents, the broker-dealer general ledger records should be posted to reflect gross sales, and purchases from principal underwriters as well as concession income related to plan transactions. This would seem to be of particular significance since the passage of the SIPIC legislation because the broker-dealer assessments to fund the insurance are based on gross revenues which would not be properly reflected according to the instructions in question.

As you are aware, the Division is currently contemplating a release to the securities industry in connection with responsibilities of certain persons registered with the Commission, including broker-dealers, relative to functions required to be performed by those members but which are actually being performed by others. The comments contained in this memorandum are consistent with the staff's over-all position in this matter. Furthermore, other considerations such as the desirability of being able to readily obtain reciprocal brokerage information from a broker-dealer's records lend to the importance of reconsidering the instructions in question.

I have discussed this matter with Karl Smeltzer and he is in general agreement.

cc: Karl C. Smeltzer