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THE ROLE OF ADVERTISING IN THE MUTUAL FUNDS INDUSTRY†

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The recent experience of mutual fund¹ net redemptions² brings into sharp focus the necessity of maintaining, if not increasing, mutual fund sales.³ Where the redemption of a fund's shares exceeds its sales by a substantial amount or for an extended period of time, the fund may have to resort to liquidating some of its portfolio securities in order to meet redemption demands.⁴ A continuing pattern of net re-

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¹ The term "mutual fund" refers to an open-end management company as defined in § 5(a)(1) of the Investment Company Act of 1940, 15 U.S.C. § 80a-5(a)(1) (1970). The distinguishing feature of the mutual fund is that an investor may redeem his shares at any time for their net asset value—i.e., the amount of the fund's net assets divided by the number of its outstanding shares.

² Mutual funds suffered net redemptions in May, June, July and September of 1971. Sales of fund shares in 1971 totalled \$5.2 billion while redemptions totalled \$4.8 billion. The \$400 million gain compares with a \$1.6 billion gain in 1970. See 136 BNA Sec. Reg. & L. Rep. A-16 (Jan. 26, 1972). During January, 1972, mutual funds experienced \$475.8 million in redemptions although sales were \$521.3 million. See Wall Street Journal, March 21, 1972, at 12, col. 3. For February, 1972, redemptions reached an all time high of \$513.9 million while sales were only \$404 million. *Id.* These sale and redemption statistics were compiled by the Investment Company Institute (ICI) and cover its members only. The ICI, however, represents member funds with more than 90% of the total assets of the mutual fund industry.

³ The term sales refers not only to "new" sales, i.e., to people who are not already shareholders but also to the reinvestment of dividends and capital gains distributions by existing fund shareholders.

⁴ Generally, mutual funds hold a certain percentage of liquid assets, e.g., cash, U.S. Government and short term bonds, for the purpose of meeting redemptions. For example,

demptions on an industry-wide basis coupled with the liquidation of fund portfolio securities could have an adverse effect on the stock market in general.⁵

Given this necessity continually to sell new shares, one would expect that the mutual fund industry would utilize extensively the primary marketing tool for American business: advertising. However, this is not the case. The Institutional Investor Study Report of the Securities and Exchange Commission⁶ (Study) found, among other things, that over forty percent of the mutual fund complex advisers surveyed considered advertising so unimportant as a promotional device that it was never used.⁷ The authors of the Study suggested that "[s]ince advertising is typically one of the lowest cost promotional devices for American business, the reasons for this lack of usage may be regulatory constraints."⁸ In the case of mutual funds, these constraints are indeed formidable.

The legal restraints on mutual fund advertising result from the fact that a mutual fund, in addition to registering with the Securities and Exchange Commission (SEC) as an investment company,⁹ must also register, pursuant to the Securities Act of 1933 (1933 Act), the shares it proposes to issue. In addition, Section 5(b)(1) of the 1933 Act¹⁰ prohibits the transmission of interstate commerce of any prospectus relating to any security unless the prospectus meets the re-

the ICI has reported that in December, 1971, the total assets of its members was \$55.1 billion, of which \$3.0 billion was in the form of cash. 136 BNA Sec. Reg. & L. Rep. A-16 (Jan. 26, 1972).

⁵ For example, if funds liquidate huge blocks of a particular security, the price of that security will drop. This drop may have no relationship whatever to the financial condition of the company involved, yet it will occur. If the liquidation occurs in a bear (down) market, it will only serve to reinforce the downward trend. Large scale liquidations may also put a strain on the operational facilities in the securities industry, which has not as yet recovered from the operational crisis of 1968-69.

⁶ H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971) [hereinafter cited as SEC Institutional Investor Study].

⁷ *Id.* at 203 table IV-39. The fund complex advisers were asked to indicate whether advertising was important for obtaining new business. The survey covered the years 1964 and 1969. Of the 29 firms responding for 1964, 48.28% considered advertising unimportant while 38.46% of the 39 firms responding for 1969 considered advertising unimportant. A fund complex was defined in the study as an "advisory firm where more than one-third of assets being advised (as of September 30, 1969) were represented by assets of registered investment companies." *Id.* at 142.

⁸ *Id.* at 196. The New York Times interpreted this suggestion as a recommendation that the existing advertising restrictions be liberalized. N.Y. Times, March 11, 1971, at 59, col. 3. The author has been informed by a reliable source connected with the Institutional Investor Study that this is exactly what was intended.

⁹ Section 7(a)(1) of the Investment Company Act of 1940, 15 U.S.C. § 80a-7(a)(1) (1970).

¹⁰ 15 U.S.C. § 77e(b)(1) (1970).

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quirements of Section 10 of that Act.¹¹ The term "prospectus" is defined to include, *inter alia*, any written advertisement which offers any security for sale.¹² The phrase "offers for sale" is defined to include "every attempt to offer to dispose of, or solicitation of an offer to buy, a security or interest in security, for value."¹³ Thus an advertisement which "offers for sale" a security is deemed a prospectus and therefore must conform to the requirements of Section 10 in order to satisfy Section 5(b)(1).

The above statutory scheme does not prohibit *all* advertising by mutual funds. Only those advertisements which offer a security for sale are covered,¹⁴ and oral communications (except on radio and television) are not included in the definition of "prospectus" even if a security is offered for sale.¹⁵ In addition to these two exceptions, Section 2(10)(b) of the 1933 Act allows for the familiar "tombstone ad"—*i.e.*, an advertisement which "states from whom a . . . [Section 10 prospectus] may be obtained and, in addition, does no more than identify the security, state the price thereof, and state by whom orders

¹¹ 15 U.S.C. § 77j (1970). This section sets forth the detailed information required in the prospectus.

¹² Section 2(10) of the Securities Act of 1933, 15 U.S.C. § 77b(10) (1970). Advertisements on radio and television which offer securities for sale are also considered prospectuses.

¹³ *Id.* § 2(3), 15 U.S.C. § 77b(3) 1970. The phrase "for value" is important. Most funds prefer that their shareholders reinvest dividend and capital gains distributions. In fact, some funds require reinvestment. See IDS New Dimensions Fund, Inc., Prospectus 3 (March 12, 1971). If the dividends or capital gains are distributed as stock, or if the shareholder is given the option of receiving stock in lieu of cash, then the shares issued as dividends or capital gains need not be registered since there is no "sale" of shares "for value." See SEC Securities Act Release No. 929 (July 29, 1936), 1 CCH Fed. Sec. L. Rep. ¶ 1121 (1971); H.R. Rep. No. 152, 73d Cong., 1st Sess. 25 (1933).

¹⁴ The terms "offer to sell" and "prospectus" are defined broadly. They "are not limited to communications which constitute an offer in the common law contract sense, or which on their face purport to offer a security. Rather . . . they include 'any document which is designed to procure orders for a security.'" See Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 848 (1959); SEC Securities Act Release No. 2623 (July 25, 1941), 1 CCH Fed. Sec. L. Rep. ¶ 3198 (1971).

¹⁵ Oral communications are, however, subject to the antifraud provisions of the federal securities laws. See Securities Act of 1933 §§ 12(2), 17(a), 15 U.S.C. §§ 77 l (2), 77q(a) (1970). Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1971). After December 14, 1971, an investment adviser whose only clients are investment companies and who uses the mails or other instrumentalities of interstate commerce must register as an investment adviser. Investment Advisers Act of 1940 § 3(b), 15 U.S.C. § 80b-3(b) (1964), as amended, Act of Dec. 14, 1970, Pub. L. No. 91-547, § 24(a), 84 Stat. 1413. A registered investment adviser is subject to the antifraud provisions contained in that Act. *Id.* § 6, 15 U.S.C. § 80b-6 (1970). As a practical matter, it is difficult, if not impossible, to enforce these antifraud provisions except after fact. University of Pennsylvania, Conference on Mutual Funds, 115 U. Pa. L. Rev. 659, 777 (1967) (remarks of Mr. Loomis, General Counsel, SEC).

will be executed"¹⁶ Pursuant to authority granted in section 2(10), the SEC has adopted Rule 134,¹⁷ which indicates the type of information an issuer, including a mutual fund, can include in a tombstone ad.¹⁸ The Chief Counsel of the SEC's Division of Corporate Finance has interpreted Rule 134¹⁹ to allow a mutual fund to include²⁰ in a tombstone ad (1) a general indication of the type of fund, the type of its portfolio and the manner in which its shares are offered; (2) identification of the fund as a "no-load" fund or reference to the fact that it has no sales load or employs no salesmen; (3) a brief identification of the fund's policy, for example, "an investment in this fund includes diversification and participation in a broad list of companies"; (4) a listing of the industry components of the fund but only for the purpose of fairly identifying the investment policy of the fund; (5) the date the fund started in business or a simple announcement inviting the attention of special groups; and (6) the name of the fund's adviser, for identification purposes only.

In summary, a mutual fund (including its investment adviser and

¹⁶ Securities Act of 1933 § 2(10)(b), 15 U.S.C. § 77b(10)(b) (1970). Unlike tombstone ads for the usual corporate issue, those circulated by a registered open-end investment company or its underwriter must be filed with the Commission within 10 days after they are first used or published. Investment Company Act of 1940 § 24(b), 15 U.S.C. § 80a-24(b) (1970); SEC Investment Company Act Release No. 150 (June 20, 1941), 3 CCH Fed. Sec. L. Rep. ¶ 48,898 (1971). If the ad's sponsor is a member of the NASD, as most are, the ad must also be filed with it within 3 days after its first use or publication. CCH NASD Manual ¶ 5002 (1971).

¹⁷ 17 C.F.R. § 230.134 (1971).

¹⁸ In proposing to adopt Rule 134, the SEC made it clear that tombstone advertisements "are intended to be limited to announcements identifying the existence of a public offering and the availability of a prospectus and they are not to be selling literature of any kind." SEC Securities Act Release No. 3535 (March 10, 1955), CCH [1952-1956 Transfer Binder] Fed. Sec. L. Rep. ¶ 76,333. Recently, the SEC published proposed Amendments to Rule 134 and asked for public comments. See SEC Securities Act Release No. 5213, 37 Fed. Reg. 2596 (Dec. 1, 1971). These proposed amendments will be discussed more fully at pp. 1010-1015 *infra*.

¹⁹ SEC Securities Act Release No. 4709 (July 14, 1964), 1 CCH Fed. Sec. L. Rep. ¶ 1461 (1971).

²⁰ Those items of information which would *not* be within the scope of Rule 134 and which, therefore, may not be included in a tombstone ad are:

- a. a listing of the fund's portfolio or identification of those companies whose securities make up the largest holdings in the portfolio;
- b. photographs, although the investment company's trademark may be used;
- c. the name of the transfer agent, or the custodian, or a statement that assets are held by an independent custodian;
- d. statements setting forth the number of fund shareholders or the amount of total fund assets;
- e. references to fund performance relative to the Dow Jones or any other stock average;
- f. statements as to the present value of past investment in the fund; and
- g. quotations of various experts concerning industries in which the fund has invested.

underwriter),²¹ before the delivery of a prospectus meeting the requirements of section 10,²² may advertise its product either orally or by a written advertisement (including radio and television) which contains only such information as is permitted by section 2(10)(b), Rule 134 and Interpretative Release No. 4709. Of course, an advertisement which does not offer a security for sale is not considered a prospectus. As noted, however, the term "offer for sale" is broadly defined and even more broadly interpreted.²³ Further, under the federal scheme, any advertisement, written or oral, is subject to the antifraud provisions of the federal securities laws.²⁴

The result of these statutory restrictions on mutual fund advertising has forced funds to utilize other methods to encourage the sale of their shares. This article will review those other methods and recent developments which may jeopardize their continued availability. It will also consider the legislative policy underlying the advertising restrictions as well as the recent SEC proposals which relax the existing restrictions on mutual fund advertising. Finally, consideration will be given to problems that would confront those mutual funds which decide to advertise extensively their product.

²¹ A fund's investment adviser and underwriter are subject to the same restrictions as the fund itself since both are "persons" as defined by § 2(2) of the Securities Act of 1933, 15 U.S.C. § 77b(2) (1970). The prohibitions in § 5 apply to "any person." Id. § 5, 15 U.S.C. § 77e (1970).

²² This is not to say that once a prospectus meeting the requirements of § 10 is delivered to the investor all regulation over advertising ceases. The National Association of Securities Dealers, Inc. (NASD), which is the only national securities association registered pursuant to § 15(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3(a) (1970), and which in fiscal year 1971, had 4,390 member broker-dealers, 37 SEC Ann. Rep. 87 (1971), administers as to its members the SEC's Statement of Policy with regard to investment company advertising and supplementary sales material. See CCH NASD Manual ¶ 5001-253 (1971). The SEC administers its Statement of Policy as to those broker-dealers who are registered with it but who are not members of the NASD. In fiscal year 1971, there were 301 such broker-dealers. 37 SEC Ann. Rep. 94. For a discussion of the NASD's role in the area of mutual fund advertising, see Matlin, *The Trials and Tribulations of Mutual Fund Advertising*, Inst. Inv. 21, 25 (March, 1971).

²³ See note 14 supra.

²⁴ See note 15 supra. Mutual fund advertising may also be subject to state Blue-Sky Laws. In California, for example, any advertisement (defined in Cal. Corp. Code § 25002 (West Supp. 1971)) concerning a security must be filed with the California Securities Commission at least 3 days prior to its publication. Id. § 25300(a). Any ad which is permitted or required by § 5(b)(2) or § 2(10)(b) of the Securities Act of 1933 and concerns a security registered under that Act need not be filed. Id. § 25300(b)(4). An advertisement (other than a tombstone) relating to the securities of an investment company registered under the Investment Company Act of 1940 will not be disapproved if it complies with the SEC's Statement of Policy. Cal. Admin. Code, tit. 10, § 260.302(h) in CCH Blue Sky Rep. ¶ 8637 (1972). See also H. Marsh, Jr. & R. Volk, *Practice Under The California Corporate Securities Law of 1968*, 382-94 (1969).

I. THE SALE OF MUTUAL FUND SHARES

Because of the legal restraints on mutual fund advertising, most funds have developed distribution systems whose object is to maximize fund sales. Prior to a consideration of the role which more liberalized advertising rules might have in this sales effort, existing methods of distributing fund shares will be considered.

A. *The Mutual Fund Structure*

Most mutual funds are unique in that the day-to-day operations of the fund are contracted out to an investment adviser which, although it may have formed and promoted the fund, remains a separate and distinct organization.²⁵ It is not uncommon for one advisory organization to form and manage a group of funds, commonly known as a fund complex.²⁶ In return for a management fee, which usually is based on a percentage of the fund's net assets,²⁷ the adviser provides the fund with investment research and analysis and makes the investment decisions concerning the fund's portfolio. Besides the advisory function, the management fee may cover such nonadvisory expenses as the salaries of the fund's officers and directors, and the cost of office space and bookkeeping services.²⁸ Except for no-load funds,²⁹ the management fee does not cover, nor does the fund adviser usually engage in, the distribution of fund shares. This function belongs to the fund's principal underwriter.³⁰

²⁵ Some funds are internally managed, that is, they maintain an in-house management staff. For a discussion of internally versus externally managed investment companies see, SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 102-14 (1966) [hereinafter cited as PPI].

Since publication of the PPI, the MIT complex described in the report, *id.* at 104-06, has switched to external management. See Memorandum of the SEC as amicus curiae in opposition to the proposed settlement in *Gross v. Moses*, 115 BNA SEC Reg. & L. Rep., (Aug. 18, 1971) at F-1.

²⁶ PPI, *supra* note 25, at 47-49. For a comprehensive discussion of mutual fund complexes, see Glazer, *A Study of Mutual Fund Complexes*, 119 U. Pa. L. Rev. 205 (1970) [hereinafter cited as Glazer].

²⁷ The Institutional Investor Study found that 73% of the advisers to registered investment companies surveyed based their fees on a percentage of assets under management. SEC Institutional Investor Study, *supra* note 6, at 209. The average advisory fee ratio (i.e., 1969 advisory fee divided by total assets under advisement as of Sept. 30, 1969) for registered investment companies was 0.45%. *Id.* at 208, 216 (table IV-43).

²⁸ There is no "standard" advisory contract. The services which are provided the fund by the adviser in return for the fee vary among funds. *Id.* at 207; PPI, *supra* note 25, at 90-92. Some funds charge two fees, one covering only the advisory services and the other covering administrative expenses. *Id.* at 92-94.

²⁹ A no-load fund is one which sells its shares at net asset value without the imposition of a sales load. PPI, *supra* note 25, at 204. See discussion at pp. 965-66 *infra*.

³⁰ For a discussion of the role of the principal underwriter of a mutual fund see PPI, *supra* note 25, at 54-55.

B. *Who Distributes Fund Shares*

There have developed over the years four main types of mutual fund distribution organizations. The first is what has been termed a fully-integrated organization.³¹ Such an organization may consist of one company that acts both as adviser and principal underwriter to a fund or fund complex; or it may consist of separate but affiliated companies, with one providing advisory services and another acting as principal underwriter. The major feature of the fully-integrated organization is that it employs, either on a full or part-time basis, its own "captive" sales force, that is, retail salesmen who sell fund shares directly to the public.³² The salesmen in the fully-integrated organization resemble the more familiar insurance agent and, in fact, they may sell, in addition to fund shares, life insurance policies, variable annuities, face-amount certificates and periodic investment plans which are issued by companies affiliated with the principal underwriter.³³

The second main type of distribution organization is best described as semi-integrated. Unlike the fully-integrated organization, it distributes fund shares not only through a captive sales force but also through independent broker-dealers who may offer to the public the shares of many different funds.³⁴ In some cases, even the captive retailers of the principal underwriter may sell the shares of other funds,³⁵ although they are encouraged to sell the shares of the funds with which the principal underwriter is affiliated.

A third type of distribution organization is one which does not consist of an organization in the formal sense. A small number of funds sell their shares *directly* to the public, at a price equal to their current net asset value. These funds charge no sales load (hence the name "no-load"), although they may impose a redemption charge. Without a

³¹ SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 102-04 (1963) [hereinafter cited as Special Study]; PPI, *supra* note 25, at 56.

³² Since fully-integrated organizations like Investment Diversified Services (IDS) sell their fund shares directly to the public and their salesmen do not sell the shares of other funds, there is no need for the dealer discount afforded to members of the NASD. See Art. III, § 26(c) of The NASD's Rules of Fair Practice, CCH NASD Manual ¶ 2176 (1971). Thus there is no advantage to joining the NASD. Special Study, *supra* note 31, at 103. However, they must still meet the qualifications set by the SEC for broker-dealers. Securities Exchange Act of 1934 § 15(b)(8), 15 U.S.C. § 780(b)(8) (1970); 17 C.F.R. § 240.15b8-1 (1971).

³³ Special Study, *supra* note 31, at 103.

³⁴ *Id.* at 104.

³⁵ Unlike the participants in the fully-integrated organization, those in the semi-integrated organization are usually members of the NASD, so as to be eligible for the dealer discount which is available only to NASD members. NASD, Rules of Fair Practice, Art. III, § 26(c), CCH NASD Manual ¶2176 (1971). The dealer discount is important to those captive retailers who sell the shares of other funds.

sales load, these funds cannot support a more formal sales organization³⁶ and their promotional activities are limited to tombstone ads published by their investment advisers.³⁷ No-load funds are generally sponsored either by established counseling firms or by brokerage concerns as a service to their clients.³⁸

The fourth and predominant type of distribution organization is the non-integrated distribution organization.³⁹ Unlike the fully- and semi-integrated organizations, this system does not utilize captive retail salesmen. Rather, the fund sells its shares on a wholesale basis to independent broker-dealers who then retail them to the public. The principal underwriter, one usually affiliated with the investment adviser of the fund which it underwrites, endeavors to involve as many broker-dealers as possible in the distribution system, in order to get maximum exposure for the shares of its funds.⁴⁰ Naturally, involving broker-dealers also entails devising ways to compensate them.

C. *Compensation of Participants in the Sales Process*

1. *Apportioning the Sales Load*

In offering their shares to the public, most mutual funds impose a sales charge, which the investor pays in addition to the current net asset value of the shares purchased. Although the sales load may vary among funds, the prevailing rate is 8.5 percent of the total purchase price or, expressed differently, 9.3 percent of the amount actually invested.⁴¹ Some funds provide for a "sliding" sales charge which varies

³⁶ Some no-load funds sell their shares through an underwriter which is owned by the fund's adviser. Since there is no sales charge to cover the expenses of the underwriter, it is subsidized by the adviser. See Glazer, *supra* note 26, at 210 n.40.

³⁷ Special Study, *supra* note 31, at 110. No-load funds may also induce retail dealers to sell their shares by directing fund portfolio brokerage to them. PPI, *supra* note 25, at 59. For a more complete discussion of this use of portfolio brokerage as a reward for selling fund shares, see text accompanying notes 51-81 *infra*.

³⁸ Special Study, *supra* note 31, at 110; PPI, *supra* note 25, at 58-59.

³⁹ Special Study, *supra* note 31, at 105-07.

⁴⁰ In order to be eligible for the dealer discount both the principal underwriter and the independent broker-dealers must be members of the NASD. NASD, Rules of Fair Practice, Art. III, § 26(c), CCH NASD Manual ¶ 2176 (1971). In addition, a sales agreement must be in effect between the underwriter and the individual broker-dealers. *Id.* § 26(c)(2).

⁴¹ At a rate of 8.5%, a sales load of \$8.50 is deducted from a \$100 purchase. Thus, \$91.50 is actually invested. The \$8.50 is approximately 9.3% of \$91.50. PPI, *supra* note 25, at 52. The SEC considered this sales load too high when compared to the costs of other securities transactions. *Id.* at 209-15. It recommended that the sales load not exceed 5% of the net asset value of the fund share. *Id.* at 223. The 1970 Investment Company Amendments Act changed the "unconscionable or grossly excessive" standard of § 22(b) of the Investment Company Act of 1940 to require that the price at which a mutual fund share is offered or sold to the public shall not include "an excessive sales load." Act of Dec. 14, 1970, Pub. L. No. 91-547, § 12, 84 Stat. 1413. The SEC has the final say as to what is an "excessive sales load." *Id.*

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as the amount invested increases. For example, an investor who invests \$10,000 or less may pay the full 8.5 percent, while an investor who invests \$75,000 may only pay a sales charge of 4.0 percent.⁴² The sales load is set by the fund; it is illegal for any dealer to sell the shares of a fund for less than their net asset value, plus the prescribed sales load.⁴³

In almost all cases, the sales load is used to pay the costs of distributing fund shares, that is, to pay participants in the distribution chain. In the case of fully- and semi-integrated organizations which maintain their own captive sales forces, the principal underwriter usually retains a portion of the sales load to cover its overhead and other expenses connected with the distribution and sale of the shares of the fund.⁴⁴ The remainder of the sales load is used to compensate sales supervisory personnel, as well as the salesmen who actually sell the shares. Since the retail salesmen are compensated on a commission basis, their total compensation is limited only by the number of shares that they can sell.⁴⁵

The allocation of the sales load is somewhat different for non-integrated organizations and that part of the semi-integrated organization which utilizes independent broker-dealers. As previously noted, a majority of funds distribute their shares through a principal underwriter that sells them on a wholesale basis to many broker-dealers,⁴⁶ who then retail them to the public at their "current offering price," that is, current net asset value plus the prescribed sales load.⁴⁷ From

⁴² PPI, *supra* note 25, at 52. Most mutual funds allow an investor to submit a statement of intention whereby the investor indicates that he will purchase more fund shares within thirteen months of his initial investment. If the investor does purchase the shares during the period, his total investment is viewed as having been made at one time and the sales load is reduced. For an example of this procedure, see *id.* at 205-06.

⁴³ See § 22(d) of the Investment Company Act of 1940, 15 U.S.C. § 80a-22(d) (1970). This section is accurately described as the 1940 Act's resale price maintenance provision. PPI, *supra* note 25, at 218. The failure of the 1970 Investment Company Amendments Act to repeal § 22(d) may indicate that that section is to prevail over any other conflicting law of the United States, including the antitrust laws, with regard to resale price maintenance. Act of Dec. 14, 1970, Pub. L. No. 91-547, § 12(c), 84 Stat. 1413.

⁴⁴ Section 15(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-15(b) (1970) makes it illegal for an underwriter to "offer for sale, sell, or deliver after sale any security . . ." of a registered investment company unless pursuant to a written contract which sets forth the terms of the agreement. The major incidental expenses of the underwriter are the cost of printing and distributing prospectuses and supplementary sales material supplied to retailers and other promotional activities (including advertising). Special Study, *supra* note 31, at 109.

⁴⁵ For a discussion of the sales techniques used by mutual fund salesmen, see Special Study, *supra* note 31, at 124-39.

⁴⁶ See text accompanying note 34 *supra*.

⁴⁷ See text accompanying note 41 *supra*. Since both the underwriters and the broker-dealers involved in the non-integrated and semi-integrated organizations are usually members of the NASD, so as to avail themselves of the dealer discount, they are pro-

an 8.5 percent sales load, the principal underwriter usually retains from 0.50 to 2.5 percent, while the independent broker-dealer retains the remaining 6.0 to 8.0 percent.⁴⁸ As in the case of the fully-integrated organization, the part of the load retained by the principal underwriter is used to cover overhead and incidental expenses and, it is hoped, to provide a profit. Of the portion retained by the broker-dealer, part (usually one-half) is to cover the broker-dealer's overhead and other expenses, with the remainder (the other half—three to four percent—going to the dealer's salesmen actually selling the shares.

Since the independent broker-dealers may sell the shares of many funds, a principal underwriter must somehow induce them to sell the shares of its funds rather than those of other funds. The usual method used by fund underwriters is to vary the dealer concession, that is, to give the broker-dealers a larger share of the sales load for selling the fund shares distributed by the underwriter. In the case of the semi-integrated organization, the underwriter usually gives its captive retailers a larger share of the sales load for selling the shares of its fund than it does when the retailer sells the shares of another fund.⁴⁹ Similarly, an independent broker-dealer can induce a salesman to sell the shares of a particular fund (e.g., one which grants a larger concession to the dealer) simply by giving the salesman a higher concession for selling the shares of that fund.

2. *Use of Portfolio Brokerage to Reward Those Who Sell Fund Shares*⁵⁰

In addition to the direct compensation resulting from allocation of the sales load, retail broker-dealers often receive extra compensation in the form of brokerage commissions generated by a fund's portfolio transactions.⁵¹ Since a fund's investment adviser usually has absolute

hibited from purchasing mutual fund shares except to cover purchase orders already received. NASD, Rules of Fair Practice, Art. III, § 26(f)(2), CCH NASD Manual ¶ 2176 (1971).

⁴⁸ PPI, supra note 25, at 207. Special Study, supra note 31, at 108-09.

⁴⁹ PPI, supra note 25, at 207-08. In the semi-integrated organization both the underwriter and salesmen are broker-dealers and members of the NASD. See note 35 supra. Since the captive retailers in this type of organization sell the shares of funds other than those of the principal underwriter, the underwriter is in effect a dealer and is entitled to a dealer's concession on the sale of fund shares, other than its own, which its captive retailers sell. Thus it can vary the salesman's commission to induce him to sell the underwriter's fund shares. See, e.g., PPI, supra note 25, at 208 n.29.

⁵⁰ The allocation of fund portfolio brokerage commissions has been the subject of considerable study by the SEC and others. See Special Study, supra note 31, at 213-35; Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 525-39 (1962) [hereinafter cited as the Wharton Report]. See also Glazer, supra note 26, at 250-59.

⁵¹ A fund's investment adviser continually purchases and sells securities for the fund's portfolio. The average annual turnover rate (defined as total cash purchases or

discretion in placing fund portfolio business⁵² (recall that a fund's adviser is usually also the underwriter or closely affiliated with the underwriter), it can channel brokerage commissions to those broker-dealers who sell its fund shares.⁵³ The use of fund portfolio brokerage as a reward for sales is possible because, under a system of fixed minimum commissions,⁵⁴ the commissions paid by a fund⁵⁵ are frequently far in excess of the actual cost of executing the fund's order. The SEC has noted that "[a]lthough a large order may make greater demands on a broker than a small one, member brokers can profitably execute and clear transactions for investment companies and other large institutional customers at a cost which is only a fraction of the commissions they must charge."⁵⁶ The difference between the actual cost of execution and the commission paid has come to be known as "disposable brokerage"⁵⁷ or "soft dollars." These dollars are used both to reward those who sell fund shares⁵⁸ and to compensate broker-dealers who

total cash sales, whichever is smaller, of common stock during the 12 months preceding September 30, 1969, divided by the average market value of the common stock during the previous 12 month period) for registered investment companies was 56.7 percent. SEC Institutional Investor Study, *supra* note 6, at 170, 189 (table IV-29). The study found also that accounts advised in fund complexes (defined as an advisory firm where more than one-third of the assets being advised, as of September 30, 1969, were represented by assets of registered investment companies) tended to have substantially higher turnover rates. *Id.* at 174, 192 (table IV-32).

⁵² The Institutional Investor Study found that in 65% of the cases where the adviser to a registered investment company places purchases and sell orders, the adviser had total (100%) discretion in allocating brokerage business. SEC Institutional Investor Study, *supra* note 6, at 169, 188 (table IV-28). In 27% of the cases, the client (the fund) designated the allocation of the brokerage business. *Id.*

⁵³ Fully-integrated organizations like IDS do not have to use portfolio brokerage as an added inducement to dealers to sell their fund shares since they are sold by a captive retail force. PPI, *supra* note 25, at 165. Such an organization may, however, use portfolio brokerage to compensate broker-dealers who provide the fund with other services such as supplementary research. See IDS New Dimensions Fund, Inc., Prospectus 6 (March 12, 1971). In some cases the salesman received a portion of the reciprocal brokerage on the portfolio transactions of the fund whose shares he sold. Special Study, *supra* note 31, at 124. In other cases, the salesman receives, in lieu of a portion of the portfolio brokerage, a higher percentage of the sales load for selling funds which will direct reciprocal brokerage to his employer. *Id.*

⁵⁴ All national securities exchanges (NYSE, Amex and the regional stock exchanges) require their members to charge established minimum commissions to nonmembers. See, e.g., NYSE Const., Art. XV, § 2(a), (b), 2 CCH N.Y. Stock Exch. Guide ¶ 1702 (1972). In the over-the-counter (OTC) and third markets (over-the-counter trading in exchange listed securities) there are no fixed minimum commissions. Rather, market-makers compete with each other on a price basis, that is, they purchase and sell securities on a principal basis and make their profits on the spread between their purchase and sale price. In the fourth market, buyers and sellers usually deal directly with each other. For a general discussion of the various securities markets see, PPI, *supra* note 25, at 156-61.

⁵⁵ The commissions charged on fund portfolio transactions are a capital expense of the fund. They are not an expense which is covered by the management fee.

⁵⁶ PPI, *supra* note 25, at 163.

⁵⁷ *Id.* at 162-63.

⁵⁸ The Institutional Investor Study found that in 1968 "[m]ost fund commission

provide the fund's investment adviser with other services, such as research,⁶⁰ portfolio valuation and communication facilities.⁶⁰

a. *Direct Reciprocity*.—The simplest way to channel portfolio brokerage to broker-dealers who sell fund shares is to place fund portfolio business directly with them. As in so many cases, however, the simplest way is not always possible. The shares of a particular fund may be sold by hundreds, even thousands of independent broker-dealers, some of whom are members of a national securities exchange while others operate only in the over-the-counter (OTC) market. It would be impractical, if not impossible, to direct portfolio business to all of them. Some of the non-exchange member broker-dealers do little more than sell mutual fund shares⁶¹ and they typically do not make markets in either listed⁶² or unlisted securities. If such a broker-dealer were to receive an order from a fund, it would have to take it to a market-maker for execution. The SEC has held in one case that "the use of a broker-dealer to execute transactions on behalf of the Funds in securities in which such broker-dealer did not make a market, constituted a fraud upon the Funds and their shareholders."⁶³ This ruling was based on the finding that the officers of the funds involved "had a fiduciary responsibility to the Funds and their shareholders to seek the most favorable execution of portfolio transactions . . ."⁶⁴ and that paying a broker-dealer (in this case one selling fund shares) a fee for executing an order through a market-maker, when the fund could

dollars . . . were paid to mutual fund sellers." H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2284 (1971) [hereinafter cited as SEC Institutional Investor Study]. "[O]f 40 investment company complexes whose funds were distributed by independent broker-dealers . . . 62 percent of the commission paid (to the random sample of broker-dealers) was paid to sellers of their funds." *Id.* Of these 40 complexes, "nine . . . distributed at least 90 percent of their commission dollars to sellers of their shares. An additional 10 distributed between 70 and 90 percent to fund sellers." *Id.* at 2294 (table XIII-83).

⁵⁹ For calendar year 1968, the advisers to 49 fund complexes surveyed allocated \$58.3 million, or 23.1% of their \$252.1 million in commissions for research. The median investment company complex paid out 27.3% of its commissions for research. SEC Institutional Investor Study, *supra* note 58, at 2263, 2267 (table XIII-68). Some funds, notably the smaller dealer-distributed ones, allocate almost all their portfolio brokerage for research since they cannot afford to maintain a full-time research staff. PPI, *supra* note 25, at 166-67.

⁶⁰ SEC Institutional Investor Study, *supra* note 58, at 2273-74.

⁶¹ Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1971) requires a broker-dealer whose activity is limited to purchasing and selling mutual fund shares and who meets other specified requirements to maintain net capital of only \$2,500 while broker-dealers generally are required to maintain net capital of not less than \$5,000.

⁶² The trading of exchange listed securities in the OTC market is commonly known as the "third market." See PPI, *supra* note 25, at 159-61.

⁶³ Delaware Management Co., [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,458 at 82,886.

⁶⁴ *Id.* at 82,885.

have gone directly to the market-maker, was a breach of their fiduciary duty to obtain the "best execution."⁶⁵

In the case of broker-dealers who belong to an exchange, the problems are slightly different since all national securities exchanges have fixed minimum-commission rates which their members must charge nonmembers. Thus a fund pays the same commission regardless of which member or member firm executes the order. Most fund managers, however, believe that placing orders with all the exchange member broker-dealers who sell shares of their fund would "impose an undue burden on their trading departments and would be inconsistent with good portfolio management."⁶⁶ Before the customer-directed give-up was abolished in December, 1968,⁶⁷ it was common practice for funds to place their orders with a few primary or "lead" brokers because not all the exchange member broker-dealers which the fund wished to reward for selling fund shares had the capacity to execute fund-size orders.⁶⁸ The lead broker would then give up a portion of the commission received upon executing the order to other exchange members designated by the fund. In this way, a fund could use the most experienced and qualified brokers to execute its portfolio transactions while at the same time rewarding other broker-dealers who sold its shares. Since give-ups were abolished, the number of NYSE members receiving commission business directly from investment companies has increased.⁶⁹

Techniques have developed whereby broker-dealers who sell fund shares but who are not members of the NYSE can benefit from the reciprocal business placed with NYSE members. For example, a fund could place portfolio business with an NYSE firm "courtesy of" an

⁶⁵ See also Consumer-Investor Planning Corp., [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,677; Glazer, *supra* note 26, at 241-44.

⁶⁶ PPI, *supra* note 25, at 167. Since most portfolio transactions involve stock which is listed on the NYSE, there is considerable incentive for NYSE members to sell fund shares. In 1969, NYSE members accounted for 38% of total fund sales. SEC Institutional Investor Study, *supra* note 58, at 2284. Some NYSE listed stock is also traded on regional exchanges and in the third-market. To the extent that best-execution is obtained, a fund could execute orders through members of the regional exchange or a third market broker-dealer, thus providing them with commissions as a reward for selling fund shares.

⁶⁷ The use of give-ups will be discussed more fully at text accompanying notes 71-81 *infra*.

⁶⁸ In 1966 the average mutual fund order executed on the NYSE was 1,730 shares. In 1969, the average order was 3,726 shares. SEC Institutional Investor Study, *supra* note 58, at 2169 (table XIII-7). In addition, many NYSE members do not have floor brokers or clearance facilities of their own, and must execute their orders through other members who do maintain such facilities. PPI, *supra* note 25, at 168 n.59.

⁶⁹ SEC Institutional Investor Study, *supra* note 58, at 2205. Most funds, of course, still place orders with their former "lead" brokers. In addition, they may place orders with the smaller broker-dealers described in the preceding footnote. The small broker-dealer charges the fund the full NYSE commission but must pay out of the commission a floor brokerage and clearance fee to the member firm which provides those services.

OTC broker-dealer who sells fund shares. In return, the NYSE member might place some of its unrelated OTC business with that broker-dealer.⁷⁰ In the case of a broker-dealer not a member of the NYSE but belonging to a regional exchange, the NYSE member can reciprocate by placing its regional exchange business with that broker-dealer. This latter situation usually involves dually listed securities, since most of the securities traded on regional exchanges are of local interest only. In return for reciprocals received "courtesy of" the regional exchange member, the NYSE member (who may also be a member of the same regional exchange) will execute unrelated transactions on that exchange but the execution ticket will be made out to the regional member who will then be entitled to a portion of the commission. By using these techniques, a fund can use its portfolio brokerage to reward sellers of its shares.

b. *Customer-Directed Give-Ups*.⁷¹—Prior to December 5, 1968, the primary method used by mutual funds to channel portfolio brokerage to broker-dealers who sold fund shares was the customer-directed give-up. As noted, through this device a broker-dealer who received commissions for executing fund orders would, at the fund's direction, give up a portion of the commission received to another broker-dealer who had not participated in the execution but who had sold fund shares or provided other services to the fund. An NYSE member firm prohibited from sharing commissions with nonmembers⁷² would often be willing to give up from sixty to seventy percent of the commissions received on fund business to other members of the exchange.⁷³

On the regional exchanges a fund had much more latitude. Besides being able to allocate give-ups to other members of the exchange, most regional exchanges allowed a member to give up part of its commissions to broker-dealers who were not members of the exchange but

⁷⁰ PPI, supra note 25, at 168.

⁷¹ Prior to their abolition, customer-directed give-ups received the scrutiny of the SEC. See Special Study, supra note 31, at 213-35; PPI, supra note 25, at 169-88; SEC Institutional Investor Study, supra note 58, at 2182-2213; University of Pennsylvania, Conference on Mutual Funds, 115 U. Pa. L. Rev. 659, 823-54 (1967); Comment, Conflicts of Interest in the Allocation of Mutual Fund Brokerage Business, 80 Yale L.J. 372, 380-81 (1970).

⁷² NYSE Const., Art. XV, § 1, 2 CCH N.Y. Stock Exch. Guide ¶ 1701 (1971).

⁷³ PPI, supra note 25, at 170. There were two major types of give-ups: give-up by check and the floor give-up. In the former, the confirming broker would send checks at the end of each month to the other brokers designated by the customer. In the case of the floor give-up, the broker-dealer would execute the order but another broker designated by the customer would confirm it. The latter would receive the full commission out of which it would pay the executing broker a floor brokerage commission (usually 10% of the full commission) and perhaps a clearing commission (another 10%) if the executing broker also cleared the trade. SEC Institutional Investor Study, supra note 58, at 2183.

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who were members of the NASD.⁷⁴ The SEC's report on the Public Policy Implications of Investment Company Growth (PPI) described how mutual funds made use of the regional exchanges:

The large orders that the funds usually place can seldom be matched on the floor of a regional exchange with either an order of corresponding size or a sufficient number of smaller orders to permit the execution of a trade. Thus, fund orders on regional exchanges are given either to an NYSE member firm which is also a regional exchange member or to one of a small number of regional-only members who specialize in large transactions

. . . .

When a regional exchange member has "found the other side," settled the price, and arranged for the transaction, he instructs a floor broker on the regional exchange to sell a specified quantity of a particular security on behalf of a designated seller at a prearranged price and to buy the same quantity of the same security at the same price on behalf of a designated buyer. A transaction of this type is known as a "cross." Each side to the transaction pays . . . a full exchange commission. . . .

A small portion of the resulting commission (usually about 10 per cent) goes to the floor broker. The balance is paid to the broker who actually brought the parties together and he, in turn, pays an agreed portion to the over-the-counter dealers and/or regional-only members whom his clients wish to benefit for services unrelated to the transaction.⁷⁵

The SEC questioned the use of the customer-directed give-up to reward broker-dealers who sold fund shares. In its view, "[a]lthough the commissions are generated by fund portfolio transactions and are paid by the funds, their use as extra compensation for sales of fund shares benefits the adviser-underwriters and the retail sellers of fund shares rather than fund shareholders."⁷⁶ Since mutual fund advisers are usually paid a percentage of the fund's net asset worth, increased sales would increase their compensation. This, the SEC concluded,

⁷⁴ PPI, *supra* note 25, at 171 n.70. With the exception of the captive retailers in the fully-integrated organization, all broker-dealers who sell mutual fund shares are members of the NASD.

⁷⁵ *Id.* at 171-72. For another example of how a regional exchange can be used to distribute give-ups to nonexchange member broker-dealers, see SEC Institutional Investor Study, *supra* note 58, at 2185-86.

⁷⁶ SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 172 (1966) [hereinafter cited as PPI]. See also Glazer, A Study of Mutual Fund Complexes, 119 U. Pa. L. Rev. 205, 252-53 (1970) [hereinafter cited as Glazer].

may induce some advisers to turn over the fund's portfolio more often, to allocate most of the brokerage for sales rather than for other services which may be more valuable to the fund, such as research, and to engage in other practices which would be detrimental to the fund's shareholders.⁷⁷

On a much broader level, the SEC also questioned whether the extensive use of customer-directed give-ups did not "raise questions as to the propriety of the [fixed minimum] commission rate schedule itself."⁷⁸ The Commission was of the opinion that, "[a]ssuming 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."⁷⁹ The willingness of brokers to give up a substantial part of their commissions indicated to the SEC that the existing minimum commission rates might be too high.

In January, 1968, the SEC proposed to adopt Rule 10b-10⁸⁰ under the Securities Exchange Act of 1934. The proposed rule would have prohibited an investment company manager from directing a broker-dealer to give up any part of the commission on a securities transaction for an investment company unless the benefits of the division of the commission accrued to the investment company's shareholders. The release also requested comments on an NYSE proposal to institute a volume discount. Rule 10b-10 was never adopted by the SEC. The NYSE, however, "voluntarily" amended its constitution to prohibit, effective December 5, 1968, customer-directed give-ups,⁸¹ at the same time instituting a volume discount. The American Stock Exchange and

⁷⁷ PPI, *supra* note 76, at 172-82.

⁷⁸ *Id.* at 185. The SEC also considered that the use of reciprocal business practices (i.e., channeling brokerage directly to those who sell fund shares) had an adverse effect on mutual funds and their shareholders. *Id.* at 186. I. Friend, M. Blume, and J. Crockett, *Mutual Funds and Other Institutional Investors: A New Perspective* 31 (1970).

⁷⁹ PPI, *supra* note 76, at 185.

⁸⁰ SEC Securities Exchange Act Release No. 8239 (Jan. 26, 1968), [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,523.

⁸¹ See NYSE Const., Art. XV, § 1, 2 CCH N.Y. Stock Exch. Guide ¶ 1701 (1971). How "voluntary" the NYSE's action was has been the subject of dispute. In a suit brought against the SEC by the Independent Broker-Dealers' Association, the Circuit Court of Appeals for the District of Columbia held that the SEC's "requests" to the NYSE to abolish give-ups was "agency action" within the meaning of the Administrative Procedure Act and that the district court had jurisdiction to determine whether such agency action was *ultra vires*. The court, however, considered the merits and found that the SEC's action was within its powers and therefore remanded the case and ordered the district court to enter summary judgment in favor of the SEC. *Independent Broker-Dealers' Ass'n v. SEC*, 442 F.2d 132 (D.C. Cir. 1971), cert. denied, — U.S. —, 92 S. Ct. 63 (1971).

all the regional stock exchanges contemporaneously abolished the give-up and instituted a volume discount schedule.

II. RECENT DEVELOPMENTS AFFECTING THE USE OF PORTFOLIO BROKERAGE FOR SALES

A. *Abolition of the Customer-Directed Give-Up: the Aftermath*

Although customer-directed give-ups have been abolished, mutual fund managers still engage in reciprocal business practices in order to reward those who sell the shares of their funds.⁸² In addition to directly placing fund business with more broker-dealers, fund managers have used increasingly more sophisticated reciprocal practices. For example, as noted previously, fund portfolio business is placed with an NYSE member for execution on that exchange "courtesy of" another broker-dealer who is a member of a regional exchange. In return for this business the NYSE member, who may also be a member of the same regional exchange, will arrange an unrelated trade, usually in dually listed stock, on the regional exchange.⁸³ The NYSE-regional exchange member will then "give up" the name of the designated broker for purposes of execution and/or clearing duties. In practice, however, "the duties are performed by the clearing house and the member given-up does nothing beyond acquire a generally meaningless 'responsibility' for the trade."⁸⁴ Yet, the give-up recipient in many cases is entitled to receive a substantial portion of the commission on the trade.⁸⁵ This arrangement is not classified as a prohibited give-up because the executing and/or clearing broker supposedly has performed a service entitling him to compensation. As a practical matter, however, this arrangement differs little from the customer-directed give-up which, in name at least, has been abolished.⁸⁶

The abolition of the customer-directed give-up has had a severe impact on broker-dealers who are not members of any exchange. Prior

⁸² In its recent report on the future structure of the securities markets, the SEC proposed the prohibition of the use of reciprocal portfolio brokerage as a reward for sales. SEC Policy Statement, *The Future Structure of the Securities Markets*, at 7 (Feb. 7, 1972). It has been suggested that it will be extremely difficult, if not impossible, to enforce such a prohibition. See *Wall Street Journal*, Feb. 7, 1972, at 2 col. 3.

⁸³ NYSE Const., Art. XIV, § 8, 2 CCH N.Y. Stock Exch. Guide ¶ 1658 (1970), allows an NYSE member to execute orders in listed securities on any other exchange so long as the other exchange is not in New York.

⁸⁴ Welles, *The War Between the Big Board and the Regionals: What it Means to the Business*, *Inst. Inv.*, Dec., 1970, at 26.

⁸⁵ On the Pacific Coast Stock Exchange, the give-up recipient can receive an amount equal to 40% of the nonmember commission. The amounts permitted on the Midwest Stock Exchange and the Philadelphia-Baltimore-Washington Stock Exchange are 46.5% and 50%, respectively. *Id.*

⁸⁶ For an example of another interesting reciprocity technique known as the "mirror trade," See SEC Institutional Investor Study, *supra* note 58, at 2185.

to its abolition, some regional exchanges allowed their members to give up commissions to nonmembers who belonged to the NASD; in this way, a fund could provide those broker-dealers with compensation for selling fund shares. Now, however, it would be an illegal rebate under the rules of the various exchanges for a member to give up any portion of the commission received to a nonmember. Moreover, since a fund manager is under a duty to obtain "best execution" on the fund's portfolio business,⁸⁷ it is often not possible to direct fund business to these broker-dealers.⁸⁸ In reaction to this state of affairs, some regional exchanges, no doubt at the behest of institutional investors, have reduced the price on their "seats" in order to allow small NASD members to join and thereby to participate in reciprocity practices.⁸⁹ In addition, attention has been directed to the sharp increase in use of the secondary distribution method to move large blocks of stock.⁹⁰ In a secondary distribution an institution such as a mutual fund sells a large block of stock through a group of broker-dealers who then retail the stock to their customers. William J. Casey, Chairman of the SEC, has indicated that there is "some concern that the secondary distribution may be a particularly amenable vehicle to reward retail firms that merchandised significant amounts of the fund shares . . . since it permits the inclusion of NASD-only members in the selling group."⁹¹ This concern derives from the fact that the cost to the seller (the fund) in a secondary distribution is considerably higher than in a market transaction.⁹²

B. *Introduction of the Volume Discount and Negotiated Rates*

At the same time that the customer-directed give-up was abolished all exchanges instituted a volume discount. On the NYSE, for example, the commission rate schedule remains unchanged for transactions up to and including 1,000 shares but that portion of a transaction which exceeds 1,000 shares is eligible for the volume discount.⁹³

⁸⁷ See Delaware Management Co., [1966-1967 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,458.

⁸⁸ See discussion at pp. 970-972 supra.

⁸⁹ Welles, *The War Between the Big Board and the Regionals: What it Means to the Business*, Inst. Inv., Dec., 1970, at 24.

⁹⁰ Address by William J. Casey, Chairman, Securities and Exchange Commission, before the Institutional Trading Conference, June 17, 1971, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,141 at 80,463.

⁹¹ Id. at 80,464.

⁹² The average cost to the vendor of the secondary distributions noted by the SEC was 4 to 5% of the total value involved. Id. at 80,463. This is considerably higher than the approximately 1% charged in a market transaction.

⁹³ The NYSE minimum commission schedule, including the volume discount can be found in NYSE Const., Art. XV, § 2(a)(1)-(2), 2 CCH N.Y. Stock Exch. Guide ¶ 1702 (1971). The SEC has determined to raise no objection at this time to a revised

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In effect, the volume discount lowers the commissions paid by a fund on large transactions,⁹⁴ and lower commissions, of course, mean fewer "soft dollars" available to reward fund sellers. Although volume discount requirements theoretically could be skirted, the placing of a fund order so as to avoid the volume discount, in order to generate more soft dollars with which to compensate fund sellers, could constitute a breach of the fund manager's fiduciary duty to obtain "best execution."⁹⁵

Of more immediate concern to mutual funds and other institutional investors is the effect that the recent introduction of competitive commission rates will have on the amount of soft dollars available to compensate for sales and other services. On October 22, 1970, in a letter to the President of the NYSE commenting on a proposed NYSE minimum-commission rate schedule submitted the previous June, the SEC indicated its opinion that "fixed charges for portions of orders in excess of \$100,000 are neither necessary nor appropriate."⁹⁶ On February 11, 1971, the SEC relented somewhat and indicated that it would "not object to the . . . [NYSE's] commencing competitive rates on portions of orders above a level not higher than \$500,000 rather than at the \$100,000 figure mentioned in [the] October 22 letter."⁹⁷ Members of the NYSE were informed that as of April 5, 1971, the Exchange would not enforce its minimum commission rate schedule on that portion of an order in excess of \$500,000.⁹⁸

minimum commission rate schedule. SEC, Securities Exchange Act Release No. 9351 (Oct. 5, 1971), [Current] CCH Fed. Sec. L. Rep. ¶ 78,306 (1971).

⁹⁴ Since the average mutual fund order on the NYSE in 1969 was 3,726 shares, see note 68 *supra*, most funds realized some cost saving because of the volume discount.

⁹⁵ This situation would be similar to that where a broker-dealer induces a customer to purchase mutual fund shares at a price just below the breakpoint (otherwise the customer may have been entitled to a discount on the sales load). It has been held that this course of conduct was a violation of Rule 10(b)-5. Paine, Webber, Jackson & Curtis, in [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,651; Shearson, Hammill & Co., [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,306. See also, CCH NASD Manual ¶ 5266 (1971).

⁹⁶ See SEC, Securities Exchange Act Release No. 9007 (Oct. 22, 1970) in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,918 at 80,047.

⁹⁷ SEC, Securities Exchange Act Release No. 9079 (Feb. 11, 1971) in [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,955. In response to a letter from Rep. John E. Moss (D-Cal.) inquiring as to the reason why the cutoff was raised from \$100,000 to \$500,000, SEC Commissioner Hugh F. Owens stated that "[w]hile the Commission believes that the evidence for instituting competitive rates on institutional size orders is ample and remains compelling, we have concluded that this goal might best be obtained through a gradual phasing down to the \$100,000 level." 96 BNA Sec. Reg. & L. Rep., Apr. 7, 1971, at N-3. For the text of Rep. Moss' letter to the SEC, see 95 BNA Sec. Reg. & L. Rep., March 31, 1971, at G-1.

⁹⁸ See Letter from NYSE President Robert W. Haack to all NYSE Members and Allied Members, March 26, 1971 in 96 BNA Sec. Reg. & L. Rep., Apr. 7, 1971 at M-1. The NYSE Constitution was formally amended to reflect the implementation of negotiated rates on April 19, 1971. See NYSE Const., Art. XV, § 2 in 2 CCH N.Y. Stock Exch.

With the ceiling at \$500,000 it is unlikely that many fund managers will have to negotiate commissions since the dollar amounts of most fund portfolio transactions involve significantly less.⁹⁹ The \$500,000 ceiling, however, was merely a starting point. In its recent statement on market structure the SEC informed the exchanges that, effective in April, 1972, the ceiling would be lowered to \$300,000.¹⁰⁰ In addition, Senator Harrison Williams has recently introduced legislation which would prohibit, after December 31, 1973, any exchange from enforcing or maintaining any rule fixing minimum commissions on any portion of a transaction in excess of \$100,000.¹⁰¹ If the ceiling is lowered to \$100,000, many more fund managers would find themselves negotiating commission rates on portions of large orders.¹⁰² In most cases these negotiated rates would lower the total commission paid for the execution of large fund orders and, as a consequence, would lower the number of soft dollars available to reward fund sellers.¹⁰³

Fund managers may avoid this loss of soft dollars in a number of ways—for example, by breaking up larger trades into pieces which fall below the ceiling. In this way, the maximum number of soft dollars will be generated. Use of this method, however, may cause the fund manager to be sued on the ground, among others, that he failed to obtain best execution for the fund.¹⁰⁴ A second method by which soft

Guide ¶ 1702 (1972). See also 98 BNA Sec. Reg. & L. Rep., Apr. 21, 1971, at A-12. For a discussion of the impact of negotiated rates on the securities industry, see Welles, *Living in a World of Negotiated Rates: Who Will Prosper? Who Will Fail?*, Inst. Inv., Jan., 1971 at 36.

⁹⁹ The average mutual fund order on the NYSE in 1969 was 3,726 shares. See note 68 *supra*. If it is assumed that all of these orders involved stock trading at \$40 per share (in 1969, the average price of stock traded by institutions and intermediaries was \$44 per share, SEC Institutional Investor Study, *supra* note 58, at 2167), then the average mutual fund order would involve slightly more than \$149,000.

¹⁰⁰ See SEC Statement, *supra* note 82, at 6. SEC Commissioner James Needham indicated in a recent speech that he envisioned the ceiling being lowered to \$100,000 and eventually, fully negotiated commission rates. See *Wall Street Journal*, March 3, 1972, at 6, col. 2.

¹⁰¹ See, e.g., S. 3169, 92d Cong., 2d Sess. (1972). See also Securities Industry Study: Report of the Senate Comm. on Banking, Housing, and Urban Affairs, 92d Cong., 2d Sess. 4 (Comm. Print, 1972).

¹⁰² It must be kept in mind that competitive commission rates apply only to that portion of an order which is in excess of \$500,000 (or \$100,000 if lowered). Up to \$500,000, the fixed minimum commission must be charged.

¹⁰³ For a discussion of the effect of competitive rates on mutual funds, see Welles, *Living in a World of Negotiated Rates: Who Will Prosper? Who Will Fail?*, Inst. Inv. Jan. 1971, at 40, 54-55.

¹⁰⁴ It has been suggested, somewhat facetiously, that a fund manager could defend such a suit by claiming that he had suddenly become a believer in the fantastic benefits to be derived from dollar-cost averaging. *Id.* at 40. Dollar cost averaging is the practice of buying fixed dollar amounts of securities at regular intervals regardless of price. For a discussion of dollar cost averaging see Wiesenberger Services, *Investment Companies 1969: Mutual Funds and Other Types* 68-72.

dollars may be maximized involves the fund manager's disposal of a large block of a particular stock through a secondary offering, rather than through a market transaction.¹⁰⁶ As noted, the SEC has expressed some concern about the recent increase in the use of secondary offerings.¹⁰⁶

C. *The Duty of a Fund Manager to Recapture Brokerage for the Fund*

The previous discussion focused on the methods by which fund managers use the fund's portfolio brokerage to reward those who sell fund shares and on two developments which may result in less brokerage being available for this purpose. Another recent development could very well eliminate the use of portfolio brokerage to reward for sales. In *Moses v. Burgin*,¹⁰⁷ the Court of Appeals for the First Circuit held that the manager of a mutual fund has a duty to recapture fund brokerage and that he cannot use it to reward broker-dealers for selling fund shares.¹⁰⁸ In finding such a duty, the court looked to the charter of the fund in question, which required that the fund receive full net asset value on the sale of its shares.¹⁰⁹ The court noted that "[i]f Fund receives the asset value of new shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income Fund receives from the process of selling a share is less than asset value."¹¹⁰ In so holding, the court specifically rejected the contention that management has a right, in the exercise of its business judgment, to choose between recapture of the fund's direct benefit and the use of brokerage to increase sales for the fund's indirect benefit.¹¹¹ Since the decision was based on facts which predated the abolition of the customer-directed give-up, and since the mode of recapture prescribed by the court (NASD recapture through a regional exchange), is no longer available,¹¹² the court's finding as regards

¹⁰⁶ See text accompanying notes 90-92 supra.

¹⁰⁶ Id.

¹⁰⁷ 445 F.2d 369 (1st Cir. 1971), cert. denied, sub. nom., *Johnson v. Moses*, 404 U.S. 994 (1971).

¹⁰⁸ Id. at 374. See also Miller & Carlson, *Recapture of Brokerage Commissions by Mutual Funds*, 46 N.Y.U. L. Rev. 35 (1971) [hereinafter cited as Miller & Carlson]; Butowsky, *Mutual Fund Brokerage*, 3 Rev. of Sec. Reg. 915 (May 20, 1970).

¹⁰⁹ Most fund charters prohibit the selling of fund shares at less than net asset values. See Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179, 257 (1971).

¹¹⁰ 445 F.2d at 374.

¹¹¹ Id.

¹¹² The court held that it was possible for the fund's underwriter, who was a member of the NASD, to recapture brokerage on both the Pacific Coast Stock Exchange (PCE) and the Philadelphia-Baltimore-Washington Stock Exchange (PBW). 445 F.2d at 380-81. Before the abolition of give-ups, it was possible for NASD members to receive give-ups from members of most regional exchanges. The PCE and PBW, however,

liability would appear to be of limited value.¹¹³ The decision, however, at least implicitly imposes a significant duty on management to preserve fund assets.

While recognizing a duty to recapture, the court specifically held that a fund manager need not create or acquire a broker-dealer affiliate for the purpose of recapturing brokerage if it determines, in the exercise of its business judgment, that it would not be in the best interests of the fund.¹¹⁴ If a broker-dealer affiliate is formed or acquired, however, there may be a duty to recapture. In the *In re Provident Management Corp.* case,¹¹⁵ the fund's manager directed fund portfolio orders to a particular broker-dealer who was a member of the NYSE. In return, the broker-dealer would designate the fund's affiliate broker-dealer, who was a member of the Philadelphia-Baltimore-Washington Exchange (PBW), as clearing broker on unrelated trades carried out on that exchange. The affiliate would collect and retain a clearing commission on the transaction. The SEC held that retention by the affiliated broker-dealer of commissions received under this arrangement violated the antifraud provisions of the 1933 and 1934 Acts as well as section 17(e)(1) of the 1940 Act.¹¹⁶ The Commission indicated that "[i]t was improper for . . . [the affiliated broker-dealer] to keep for itself rather than confer on the Fund the benefits attributable to Fund's assets."¹¹⁷

allowed the NASD recipients to credit them against advisory fees. The other regional exchanges allowed NASD members to receive give-ups but considered it a violation of their anti-rebate rules if these give-ups were applied against the advisory fee. *Id.* No exchange presently permits give-ups of any kind to nonmembers. See note 81, *supra*.

¹¹³ In addition to finding that the fund managers failed in their duty to recapture, the court found that they were guilty of gross misconduct under § 36 of the Investment Company Act of 1940, 15 U.S.C. § 80a-36 (1964), for not disclosing to the unaffiliated directors the possibilities of recapture. 445 F.2d at 385. Section 36 has been amended, effective June 14, 1972. See Act of Dec. 14, 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413.

¹¹⁴ 445 F.2d at 375. See also SEC Securities Exchange Act Release No. 8746 (Nov. 10, 1969), [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,761 (Loomis Letter); Miller & Carlson, *supra* note 108, at 50-53. The SEC's position with respect to institutional membership, which would require that an institution affiliated broker-dealer do a predominantly public business, would prevent many institutions from forming affiliates for the purpose of recapture. See SEC Policy Statement, *The Future Structure of the Securities Markets 8-10* (Feb. 1972).

¹¹⁵ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,937.

¹¹⁶ 15 U.S.C. § 80a-17(e)(1) (1970). This section makes it unlawful for any affiliated person of a registered investment company, or an affiliated person of such person "acting as agent, to accept from any source any compensation . . . for the purchase or sale of any property to or for such registered investment company . . . except in the course of such person's business . . . as an underwriter or broker." For a discussion of § 17(e) in the context of mutual fund brokerage see Miller & Carlson, *supra* note 108, at 47-49, 53-55; Butowsky, *Mutual Fund Brokerage*, 3 Rev. of Sec. Reg. 915 (May 20, 1970).

¹¹⁷ *Provident Management Corp.* [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,937 at 80,087. See also *Consumer-Investing Planning Corp.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,677.

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The *In re Provident Management* case does not hold that a broker-dealer affiliate can *never* retain commissions received on fund transactions. The case applies only to the situation in which the affiliate does not perform a bona fide brokerage service. The SEC has argued, however, that a fund-affiliated broker-dealer is under a duty to recapture and credit to the fund commissions that it receives on fund portfolio transactions. In *Kurach v. Weissman*¹¹⁸ the SEC argued that a proposed settlement agreement whereby the fund's broker-dealer affiliate (also the fund's underwriter) would offset against the advisory fee the net profits derived from the execution of the fund's portfolio business was illusory. Its illusory nature results from the fact that it "offers no benefits to Fund shareholders, which they are not in any event entitled to receive . . ." ¹¹⁹ The court rejected this argument on the ground that Section 17(e) of the 1940 Act, at least by clear implication, authorizes an affiliated broker-dealer to receive and presumably to retain compensation for buying or selling property of any investment company, including portfolio securities, in the course of its business as a broker.¹²⁰ It would seem, then, that a broker-dealer affiliate is permitted to receive and retain commissions which it derives from acting as the fund's executing broker.¹²¹

An issue somewhat related to recapture is whether a fund manager violates section 17(e) by using fund portfolio brokerage as a reward for fund sales. One commentator has suggested that if increased fund sales are viewed as being of benefit only to the managers in the form of a higher advisory fee, then the sale of fund shares can only be viewed as "compensation" to the managers. Since the brokerage was not derived in the course of their business as brokers, their retention of it violates section 17(e).¹²² The same writer also argues that the underwriter exemption in section 17(e)(1) is not available since the use of fund brokerage would create a "hidden sales charge" in violation of section 22(d).¹²³ Another commentator, in

¹¹⁸ 49 F.R.D. 304 (S.D.N.Y. 1970).

¹¹⁹ *Id.* at 307. The SEC made substantially the same argument in an amicus curiae brief filed in the Second Circuit in opposition to a similar proposed settlement in the case of *Gross v. Moses*. See 115 BNA Sec. Reg. & L. Rep., Aug. 18, 1971, at F-1.

¹²⁰ 49 F.R.D. at 307-08; Miller & Carlson, *supra* note 108, at 48.

¹²¹ A broker-dealer affiliate can credit commission received on fund business against the advisory fee only on those exchanges which do not consider such an arrangement violative of their anti-rebate rules (e.g. Pacific Coast Stock Exchange). For an example of one such arrangement, see Investors Mutual, Inc., Prospectus 5 (Jan. 13, 1971).

¹²² See Butowsky, *Mutual Fund Brokerage* 3 Rev. of Sec. Reg. 915, 919 (May 20, 1970).

¹²³ 15 U.S.C. § 80a-22(d) (1970). This section requires sales at the "current public offering price described in the prospectus," which usually is net asset value plus a prescribed sales load. Since portfolio brokerage is used as extra compensation, the current offering price would be net asset value plus sales load plus brokerage expended on sales efforts; hence the hidden sales charge.

reply to the above argument, suggests that section 17(e) does not reach, nor was it intended to reach, activities based upon the fund directors' exercise of business judgment.¹²⁴ The SEC, he argues, can only reach such activities under the "gross abuse of trust" standards of section 36.¹²⁵ In light of the language in *Moses v Burgin*, it is not certain whether the business judgment defense would be sufficient.¹²⁶

D. Recommendations for a National Securities Market

On August 5, 1971, William McChesney Martin, former Chairman of the Federal Reserve Board, submitted a report on the securities markets to the Board of Governors of the NYSE.¹²⁷ In his report Mr. Martin advocated the retention, at least for the present, of fixed-minimum commission rates and the formation of a national securities exchange system which would include the present NYSE, Amex, and the regional exchanges. All stock not listed on this national exchange would continue to be traded over the counter. This national securities exchange would bar institutional membership and would prohibit members from affiliating with mutual fund management companies and from entering into fund management contracts. In addition, the third market would be eliminated—*i.e.*, securities listed on the national exchange could not be traded over the counter.

Since the report does not specify the mechanics of the proposed national securities exchange, the effect that it may have on the present method of utilizing portfolio brokerage to reward for sales is difficult to assess. If, for example, all present members of any exchange (except institutions) automatically become members of the new exchange, then the practice of splitting commissions among brokers will probably continue. Thus a fund would place an order with member broker *A* who would then send it to broker *B* for execution and possible clearing. Broker *A* would receive the full minimum commission, paying broker *B* a floor brokerage and clearing fee. In this way the fund could reward broker *A* for selling its shares and, since the fund must pay a fixed minimum commission, there is no question of failure to obtain best execution. There would also be no problem in regard

¹²⁴ See West, Mutual Fund Brokerage, 3 Rev. of Sec. Reg., 903. (June 19, 1970); Glazer, A Study of Mutual Fund Complexes, 119 U. Pa. L. Rev. 205, 246-47 (1970) [hereinafter cited as Glazer].

¹²⁵ 15 U.S.C. § 80a-36 (1970). The gross abuse of trust standard has been changed. Under new § 36(a), the SEC is authorized to bring an injunctive action against any of the persons enumerated in that section, alleging that such person has or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct. Act of Dec. 14, 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413.

¹²⁶ See text accompanying note 114 *supra*.

¹²⁷ See excerpts of the report in N.Y. Times, Aug. 6, 1971, at 47, col. 3. The Martin Report has been sharply criticized. See, e.g., Farrar, The Martin Report: Wall Street's "Great Leap Backward," Financial Analysts J., (Sept.-Oct., 1971).

to the duty to recapture since the national securities exchange as proposed would prohibit membership of a fund-affiliated broker-dealer.

The SEC itself has also called for a "Central Market System" in listed securities which would encompass the present exchanges as well as the third market.¹²⁸ In the SEC's view, such a system is necessary "[i]n order to maximize the depth and liquidity of our markets, so that securities can be bought and sold at reasonably continuous and stable prices, and to ensure that each investor will receive the best possible execution of his order. . . ."¹²⁹ The possible effects that the Central Market System envisioned by the SEC or the national exchange proposed by Mr. Martin might have on the use of portfolio to reward sales will be better assessed after more specific recommendations regarding the mechanics of such an exchange are made available.¹³⁰

IV. POSSIBLE SOURCES OF ADDITIONAL COMPENSATION FOR THOSE WHO SELL FUND SHARES

The use of fund portfolio brokerage as a reward for sales has already been affected by abolition of the customer-directed give-up and introduction of the volume discount.¹³¹ Moreover, there is a good chance that one or another of the developments discussed previously will have an adverse impact on this use of portfolio brokerage. If the use of portfolio brokerage as a reward for sales will be restricted in the future, the question arises: how will funds continue to induce broker-dealers to sell their shares?¹³²

A. *Increase of the Sales Load*

The first and most obvious way to provide additional compensation to those who sell fund shares is to raise the sales load and give the selling broker-dealer a higher selling concession. Such an increase, however, would be contrary to the expressed desire of the SEC to see the sales load reduced. In 1966, the SEC recommended that the 1940 Act be amended to prohibit a sales load exceeding five percent of the

¹²⁸ See SEC Policy Statement, *The Future Structure of the Securities Markets* 2-3 (Feb. 1972).

¹²⁹ *Id.* at 2.

¹³⁰ Since it has been determined that the use of reciprocal brokerages for sales should be prohibited, see note 81 *supra*, the SEC will likely require that any national securities system be designed so as to make its use difficult, if not impossible.

¹³¹ See text accompanying notes 86-106 *supra*.

¹³² The discussion here is limited to the semi- and non-integrated organizations since they utilize independent broker-dealers to sell their shares. Fully integrated organizations like IDS do not use portfolio brokerage as a reward for sales since they sell through a captive retail sales force. See note 32 *supra*.

net asset value of the shares sold.¹³³ The SEC recommendation was based on a finding that the typical sales load charged (8.5 percent of purchase price or 9.3 percent of the amount actually invested after deduction of the sales load) was far in excess of the charges involved in other securities transactions.¹³⁴ For example, the typical sales charge on a \$200 investment in mutual fund shares was forty percent higher than the round-trip cost of purchasing and selling shares of equal value in the exchange market.¹³⁵ The SEC argued that the high level of the sales load resulted because Section 22(d) of the 1940 Act,¹³⁶ the so-called resale price maintenance provision, prevented competition in the area of the sales load and in fact served to increase the load as fund underwriters sought to induce dealers to sell their shares.

In the course of discussions with the mutual fund industry, the SEC decided to abandon its recommendation for the five percent ceiling in favor of an industry proposal recommending that the test under Section 22(b) of the 1940 Act for evaluating the reasonableness of the sales load be changed from one prohibiting "unconscionable or grossly excessive" sales loads¹³⁷ to one prohibiting "excessive sales loads."¹³⁸ The Investment Company Amendments Act of 1970¹³⁹ incorporated this proposal and now Section 22(b) urges that the NASD shall make rules to provide that "the price at which such [redeemable] security is offered or sold to the public shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters, and for reasonable sales loads to investors."¹⁴⁰ Under the amended statute, the SEC has the final authority to determine what constitutes an excessive sales load.¹⁴¹

¹³³ See PPI, *supra* note 76, at 223. For an analysis of this proposal see, University of Pennsylvania, Conference on Mutual Funds, 115 U. Pa. L. Rev. 659, 769-807 (1967).

¹³⁴ SEC, Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 209-15 (1966) [hereinafter cited as PPI].

¹³⁵ *Id.* at 211. For an investment of \$1,120, an amount just below the median net mutual fund purchase, the typical sales load charged was more than 2½ times the cost of round-trip on the same size investment on a stock exchange. *Id.*

¹³⁶ 15 U.S.C. § 80a-22(d) (1970). This section makes it unlawful for any issuer, underwriter or dealer to sell any redeemable security at anything other than the "current public offering price described in the prospectus." This price is usually the net asset value of the share plus the prescribed sales load as described in the prospectus. No-load funds, of course, sell their shares to the public at net asset value without a sales load.

¹³⁷ Investment Company Act of 1940, § 22(b), ch. 686, tit. I, § 22, 54 Stat. 823.

¹³⁸ See Hearings on H.R. 11995, S. 2224, H.R. 13754 & H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. 865 (1969) [hereinafter cited as 1969 House Hearings].

¹³⁹ Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413.

¹⁴⁰ *Id.* § 12 (a), 84 Stat. at 1422.

¹⁴¹ The amendment provides that the NASD, within 18 months from the date of enactment of the 1970 amendments, is to adopt rules with respect to excessive sales loads. At any time after 18 months or after the NASD adopts the rules, whichever is sooner, the SEC may alter or supplement such rules in conformity with the procedures

A determination of what constitutes reasonable compensation must be balanced against the reasonableness of the sales load from the investor's point of view. Since the SEC views the use of portfolio brokerage to reward sellers of fund shares as providing little or no value to fund shareholders,¹⁴² the loss of the use of brokerage for this purpose would not likely be sufficient reason to raise the sales load. In fact, it may not even be sufficient justification for maintaining existing sales load levels. There exist some indications that, in amending section 22(b), Congress expected that sales loads would be reduced. First, the Senate Banking and Currency Committee, in its report on the bill that ultimately became law, cited the differences in transaction costs (the basis for the SEC's original recommendation that a five percent ceiling be imposed) as one reason why section 22(b) should be amended to prohibit "excessive sales loads."¹⁴³ Second, and perhaps more important, was the specific congressional command to the SEC that smaller companies be granted qualified exemptions from amended section 22(b), if it appears that such companies are subject to higher operating costs.¹⁴⁴ It seems that Congress was concerned that if the sales load were to be reduced, smaller companies would be unable to compensate adequately those involved in the distribution process and that therefore they would be unable to compete with larger companies. Any other view of the congressional mandate to the SEC would make little sense, especially in light of the fact that the SEC has far reaching but discretionary exemptive authority under Section 6(c) of the 1940 Act.¹⁴⁵

B. Adviser Subsidization of the Distribution Process

A second method to provide additional compensation to those who sell fund shares is to allow the retail broker-dealer a higher con-

set out in § 15A(k)(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o-3(k)(2) (1970). The 18 months was included to give the NASD sufficient time to study the sales load question before adopting rules. It is likely that the NASD will require the entire 18 months since the SEC considers that their study should cover more than the sales load question. See 96 BNA Sec. Reg. & L. Rep., Apr. 4, 1971 at A-10, A-11.

¹⁴² PPI, *supra* note 134, at 185. In fact, the SEC has argued that extensive use of reciprocals and give-ups to reward for fund sales may have a detrimental effect on fund purchasers. *Id.* at 179-80.

¹⁴³ See S. Rep. No. 91-184, 91st Cong., 1st Sess. 8 (1969). The commission rate schedule which existed in 1966 when the SEC's recommendation was made still exists for the most part. In 1968 the NYSE instituted a volume discount which lowered the commission rates on that portion of an order which exceeds 1,000 shares. See NYSE Const., Art. XV § 2(a), 2 CCH N.Y. Stock Exch. Guide § 1702 (1972). On June 30, 1971, the NYSE presented a revised commission rate schedule for SEC consideration, and in September, the SEC indicated that it would raise no objection to the new schedule. See note 93 *supra*.

¹⁴⁴ Act of Dec. 14, 1970, Pub. L. No. 91-547, § 12(a), 84 Stat. 1422.

¹⁴⁵ 15 U.S.C. § 80a-6(c) (1970).

cession out of the existing sales load. As noted previously,¹⁴⁶ a retail broker-dealer may retain from six to eight percent of the typical sales load (8.5 percent) charged by funds. From this amount the dealer must pay for overhead and other expenses as well as compensate the salesman who actually sold the fund shares. The remaining 0.5 to 2.5 percent is retained by the fund's underwriter, who is usually also the fund's adviser or one affiliated with the adviser.¹⁴⁷

In order to induce a broker-dealer to continue to sell its shares, if portfolio brokerage is no longer available for this purpose, an underwriter may have to raise the dealer's concession from, for example, 6 percent to 7.5 or 8 percent.¹⁴⁸ This increase may induce the retail dealer to continue to sell fund shares but it will also reduce the amount of the sales load retained by the underwriter who normally incurs, in addition to overhead expenses, other promotional expenses for advertising and the dissemination to dealers of sales material to be used in the selling of fund shares. As it is, the underwriter function may carry a low profit margin and may even operate at a loss.¹⁴⁹ If underwriting income is further reduced because less of the sales load is retained, the fund adviser may be forced to subsidize the distribution process. Some advisers will be willing to provide the subsidy in the hopes that continued sales of fund shares will increase the fund's net assets and, consequently, the amount of the advisory fee that they receive.¹⁵⁰ Others, however, may pass the cost of this subsidization to fund shareholders in the form of a higher management fee. In such a case, the adviser subsidy would be, in effect, a riskless expenditure and, in fact, could lead to higher profits for the adviser if fund assets do increase because, in addition to the higher fee rate, there would be increased assets to which it would be applied.

An increase in the management fee for the purpose of subsidizing the underwriting function¹⁵¹ is not likely to go unchallenged by the

¹⁴⁶ See text accompanying note 41 *supra*.

¹⁴⁷ E.g., one underwriter, Dreyfus & Co., distributes all but 0.5% of the sales load to the retail dealer. This is because the underwriter is also the fund's principal broker and no portfolio brokerage is used to reward sellers of fund shares. SEC, Report of Special Study of Security Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 218 (1963) [hereinafter cited as Special Study].

¹⁴⁸ In 1966 it was found that since 1950, the principal underwriters of 18 of the 28 dealer-distributed funds surveyed had raised the concession allotted to retail dealers. See PPI, *supra* note 134, at 208-09.

¹⁴⁹ For the years 1961-65, of 10 adviser-underwriters surveyed, 4 had lost money on the underwriting aspect of their operations. The median profit for the 10 adviser-underwriters surveyed was 8.7% of total income. PPI, *supra* note 134, at 122, 123 (table III-8).

¹⁵⁰ *Id.* at 125.

¹⁵¹ Discussion here is limited to load funds since most no-load funds do not utilize an underwriter to distribute their shares. Rather, shares are sold directly to the public by mail or by broker-dealers who are rewarded with the fund's portfolio business. See PPI, *supra* note 134, at 165. Moreover, many no-load funds are sponsored by well-established

SEC¹⁵² or a fund shareholder. Under Section 35(b), which was added by the Investment Company Amendments Act of 1970,¹⁵³ a fund's investment adviser "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of material nature, paid by . . . [the fund] . . . or by the security holders thereof, to . . . [the] adviser, or any affiliated person of . . . [the] adviser."¹⁵⁴ Section 35(b) was added primarily to ease the difficulty plaintiffs faced in challenging the level of management fees.¹⁵⁵ In order to obtain relief, a plaintiff had to establish the existence of "corporate waste," or that the fee amounted to gross misconduct or gross abuse of trust on the part of the fund's adviser or directors, depending on whether the fee was challenged under state law¹⁵⁶ or old Section 36 of the 1940 Act.¹⁵⁷ In addition to requiring proof of waste or gross misconduct, the courts placed great emphasis on the fact of unaffiliated director and/or shareholder ratification of the management contract.¹⁵⁸ Under new section 35(b), however, the "ultimate test, even if the compensation or payments are approved by the directors and share-holders, will not be whether it involves 'waste' of corporate assets but will be whether the investment adviser has fulfilled his fiduciary duty to the mutual fund shareholders in determining the fee."¹⁵⁹

In a suit under new section 35(b), an adviser would probably argue that an increased fee to subsidize the underwriting function is justified by the benefits accruing to fund shareholders because of increased sales¹⁶⁰ and by noting that it was the business judgment of the fund directors, including the unaffiliated directors, that the sale

brokerage houses or investment counseling firms as a service to their customers. In the case of the brokerage house sponsor, it usually has a form of captive sales force in its registered representatives.

¹⁵² Former SEC Chairman Hamer Budge, in testimony given before the Subcomm. on Finance and Commerce on the then pending Investment Company Amendments Act stated "that the fact that a fund underwriter loses money in its distribution activities does not permit an affiliated investment adviser to charge a higher management fee." 1969 House Hearings, supra note 138, at 178.

¹⁵³ Act of Dec. 14, 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1429. This section becomes effective on June 14, 1972. Id. § 30(4).

¹⁵⁴ Id. § 20.

¹⁵⁵ See S. Rep. No. 91-184, 91st Cong., 1st Sess. 5 (1969); H.R. Rep. No. 91-1382, 91st Cong., 1st Sess. 7 (1969).

¹⁵⁶ See, e.g., *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (1962).

¹⁵⁷ *Acampora v. Birkland*, 220 F. Supp. 527 (D. Colo. 1963). For a discussion of management fee litigation before the 1970 amendments see PPI, supra note 134, at 132-43.

¹⁵⁸ See, e.g., *Saxe v. Brady*, 40 Del. Ch. 474, 486, 184 A.2d 602, 610 (1962).

¹⁵⁹ S. Rep. No. 91-184, 91st Cong., 1st Sess. 15-16 (1969).

¹⁶⁰ Although the benefit of increased sales in regard to the investment adviser is clear, the benefits to fund shareholders are not. See Glazer, supra note 124, at 252-58.

of fund shares should be encouraged.¹⁶¹ In *Moses v. Burgin*,¹⁶² the court indicated that there may be situations where the fund's board of directors has no choice, irrespective of their business judgment.¹⁶³ The question of whether a court would find in a particular case that an increase in the management fee for the purpose of selling more fund shares constitutes a breach of the adviser's fiduciary duty to the fund shareholders would depend upon the facts developed in the case. The purpose of this discussion is simply to point out that it is highly questionable whether an adviser can pass the subsidization of the underwriting function on to fund shareholders in the form of a higher management fee.

C. Fund Assets

Another method of subsidizing the underwriting function, in the event that the dealer concession is raised to induce continued sales, involves the use of fund assets to pay promotional expenses otherwise borne by the principal underwriter.¹⁶⁴ There exists some question, however, as to whether fund assets are a proper source for financing the promotion of fund sales.¹⁶⁵

Under Section 10(a) of the 1940 Act,¹⁶⁶ at least forty percent of the members of a fund's board of directors must not be persons affiliated with the fund's investment adviser.¹⁶⁷ Section 10(d), however, provides that if certain specified conditions are satisfied, a fund may have a board of directors all members of which, except one, may be persons affiliated with the fund's investment adviser.¹⁶⁸ Among the

¹⁶¹ One Senate report specifically noted that new section 35(b) "is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees. It does, however, authorize the court to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee." S. Rep. No. 91-184, 91st Cong., 1st Sess. 6 (1969).

¹⁶² 445 F.2d 369 (1st Cir. 1971).

¹⁶³ *Id.* at 374.

¹⁶⁴ A more direct approach would be to pay the underwriter a fee based on the value of shares sold. The underwriter might then distribute part of the fee, under a pre-arranged schedule, to those dealers who sell fund shares. See Conference, *supra* note 133 at 780-71 (remarks of Gordon Henderson, Esq.).

¹⁶⁵ On the question of whether fund assets are a proper source for the financing of mutual fund advertising, compare the remarks of Gordon Henderson, Esq., *id.*, with those of Herbert R. Anderson, Chairman of Group Securities, Inc., *id.* at 778.

¹⁶⁶ 15 U.S.C. § 80a-10(a) (1970). After December 14, 1971, at least 40% of the directors must not be "interested persons" rather than affiliated persons. See Act of Dec. 14, 1970, Pub. L. No. 91-547, § 5(a), 84 Stat. 1413. For a definition of "interested person," see, *id.* § 2(a)(3).

¹⁶⁷ See generally Glazer, *supra* note 124 at 233-35; Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. Pa. L. Rev. 1058 (1967).

¹⁶⁸ 15 U.S.C. § 80a-10(d) (1970). This exemption from the 40% requirement was for the benefit of existing investment advisers who wished to make the fund medium available to their smaller customers. See H.R. Rep. No. 2639, 76th Cong., 3d Sess. 14

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specified conditions are that no sales load be charged on the sale of the fund's shares¹⁶⁹ and that "no sales or promotional expenses are incurred by [the fund]."¹⁷⁰ This is not to say that a no-load fund cannot use fund assets to pay promotional expenses. Only those no-load funds which utilize the section 10(d) exemption to avoid the forty percent unaffiliated director requirement of section 10(a) are specifically restricted.¹⁷¹ It appears that Congress determined that in a case where a sufficient number of unaffiliated directors (at least forty percent of the board members) was lacking on a fund's board to safeguard fund assets, limitations on the use of those assets were required.¹⁷²

The fact that the Investment Company Act does not specifically prohibit load funds, and those no-load funds meeting the requirements of section 10(a), from using fund assets to pay promotional expenses does not necessarily mean that a fund's adviser is free to use them for *any* promotional purposes. Use of fund assets to pay for the printing and distribution of the fund's prospectus or annual shareholder's report, both of which can be considered promotional in nature, is not the same as use of fund assets to pay for advertising copy or supplementary sales material to be used in selling fund shares. In the former case the documents are required to be delivered to investors and shareholders,¹⁷³ while in the latter case, the sole purpose is to aid the sale of additional fund shares.

In the case of load funds, Congress has evidenced its intent that the sales load be used to pay for sales and promotional expenses. Section 2(a)(35) of the Investment Company Act of 1940 defines the term "sales load" to mean "the difference between the price of a security to the public and that portion of the proceeds from its sale which is received . . . by the issuer . . . less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes or administrative expenses or fees which are not

(1940). This section has also been amended to substitute "interested person" for "affiliated person." Act of Dec. 14, 1970, Pub. L. No. 91-547, § 5(a), 84 Stat. 1413.

¹⁶⁹ Investment Company Act of 1940 § 10 (d)(3), 15 U.S.C. § 80a-10(d)(3) (1970).

¹⁷⁰ Id. § 80a-10(d)(5) (1970). Expenses incurred in complying with laws regulating the issue and sale of fund shares are not considered sales or promotional expenses. Id.

¹⁷¹ The promotional expenses of most, if not all, no-load funds are, however, borne by the fund's investment adviser which, in many cases, is primarily in the brokerage and/or money management business and sponsors a no-load fund as a service to its customers. See Conference, *supra* note 133, at 781 (remarks of Herbert R. Anderson).

¹⁷² See H.R. Rep. No. 2639, 76th Cong., 3d Sess. 14 (1940).

¹⁷³ Section 5(b)(2) of the Securities Act of 1933, 15 U.S.C. § 77e(b)(2) (1970) requires that a prospectus either precede or accompany any security, including mutual fund shares, carried through the mails or in interstate commerce. Section 29(d) of the Investment Company Act, 15 U.S.C. § 80a-29(d) (1970) requires a fund to distribute semi-annual reports containing specified information to its shareholders.

properly chargeable to sales or promotional activities.¹⁷⁴ This definition, however, makes clear only that the sales load is to be used to pay promotional expenses; it does not dictate that the sales load be the only source for such payments. If the latter had been the intent of Congress, presumably Congress would have so indicated as it did in section 10(d)(5). Use of fund assets to pay for promotional expenses may, however, run afoul of new section 35(b), which imposes on a fund's adviser a fiduciary duty with respect to compensation for services or payments of a material nature received from the fund.¹⁷⁵ It is arguable that the increased fund sales resulting from promotional activities paid for directly or indirectly by the fund is a form of payment to the fund's adviser.¹⁷⁶ Since little or no benefit accrues to the fund shareholders from the increased sales, the adviser's receipt of such payments may constitute a breach of his fiduciary duty to fund shareholders.¹⁷⁷

In order for this argument to be successful, it must be proved that the increased sales generated, at least in part, by fund assets are of little or no benefit to fund shareholders.¹⁷⁸ Moreover, it could be argued by fund managers that increased sales do in fact benefit fund shareholders, albeit indirectly.¹⁷⁹ For example, managers contend that a continual cash inflow through the sale of new shares and the reinvestment of dividend and capital gains distributions by existing share-

¹⁷⁴ 15 U.S.C. § 80a-2(a)(35) (1970).

¹⁷⁵ Act of Dec. 14, 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1429.

¹⁷⁶ Payment is the form of a higher management fee received by the adviser due to the increased sales. Since the typical fee arrangement is based on a fixed or sliding percentage of the fund's net assets, the gross fees received by the adviser will be increased to the extent that there are net sales of fund shares. If fund assets pay part or all of the cost of generating these increased sales, the adviser is receiving payment of a material nature to the extent that it derives the sole benefit from this use of fund assets. At least one commentator would presumably consider this to be compensation to the adviser. See Butowsky, *Mutual Fund Brokerage*, 3 Rev. of Sec. Reg. 915, 919 (May 20, 1970).

¹⁷⁷ In § 1(b)(2) of the Investment Company Act of 1940, 15 U.S.C. § 80a-1(b)(2) (1970), Congress declared that the public interest is adversely affected "when investment companies are . . . operated . . . [and] managed . . . in the interest of directors, officers, investment advisers . . . or other affiliated persons thereof . . . rather than in the interest of all classes of such companies' security holders." It has been held that the declarations contained in § 1(b) are a codification of the fiduciary obligations placed on the officers, directors and advisers of investment companies. See *Aldred Investment Trust v. SEC*, 151 F.2d 254 (1st Cir. 1945), cert. denied, 326 U.S. 795 (1946). For a discussion of the fiduciary obligations imposed by the Investment Company Act, see Greene, *Fiduciary Standards of Conduct Under the Investment Company Act of 1940*, 28 Geo. Wash. L. Rev. 266 (1959).

¹⁷⁸ New § 35(b)(1) places the burden of proving a breach of fiduciary duty on the plaintiff. Act of Dec. 14, 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1429.

¹⁷⁹ Fund shareholders could possibly benefit directly through a scaled-down management fee. Whether the decrease in the cost of management to the individual investor would offset his proportionate loss because of the use of fund assets as compensation for sales depends on how the management fee is scaled down.

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holders is beneficial to the fund since management is then not forced to liquidate portfolio securities for the purpose of meeting redemptions.¹⁸⁰ One fund manager, moreover, has claimed that, under some circumstances, positive cash inflow results in better fund performance,¹⁸¹ an obvious benefit to fund shareholders. A further benefit cited is that as a fund grows, it is more likely to attract a higher caliber of personnel for purposes of research and analysis as well as portfolio management, thus providing better management services to the fund.¹⁸² Similarly, as a fund grows, it achieves economies of scale,¹⁸³ that is, lower operating costs per dollar of assets managed, which can be passed on to fund shareholders in the form of scaled-down management fees.¹⁸⁴ It should be noted that, although fund growth may be

¹⁸⁰ See Practising Law Institute, *Mutual Funds 145-57* (Transcript series 1970) (remarks of Mr. Rothberg) [hereinafter cited as *Mutual Funds*]. This argument is bolstered somewhat by the recent net redemption experience. See note 2 *supra*. It should, however, be noted that the recent net redemption experience was the first such occurrence for the mutual fund industry as a whole in over 30 years of its recorded history. See Stovall, *Why Fund Redemptions May be Bullish*, *Forbes*, July 15, 1971, at 77.

¹⁸¹ Robert L. Sprinkel and Richard E. Boesel who are, respectively, the Chairman and President of Competitive Capital Fund, claim that "if a fund has a positive or negative cash flow of 10 per cent there is little effect on its performance, but when you get up to a 30 per cent positive cash flow, there is definite positive effect on performance." Fiske, *The In-House Performance Derby: Competitive Capital, Inst. Inv.*, Jan. 1969 at 42, 46. The Institutional Investor Study found that there was indeed a positive relationship between positive cash inflow (i.e., net sales) and performance. Because of limitations on the data used, however, the Study could not state whether the positive cash inflow preceded better performance or followed it. H.R. Doc. No. 92-64, 92d Cong., 1st Sess., 331 (1971) [hereinafter cited as *SEC Institutional Investor Study*]. The Wharton Report found that on a cumulative basis, better performance was related to increased inflow. H.R. Rep. No. 2274, 87th Cong., 2d Sess. 343-44 (1962) [hereinafter cited as the *Wharton Report*]. There is no quantitative evidence the positive cash inflow results in better performance. See *Mutual Funds*, *supra* note 180 at 147 (remarks of Mr. Meyer). See generally, Finefrock, *Mutual Fund Cash Flow*, *Fundscope*, Sept., 1971, at 27.

¹⁸² See Glazer, *A Study of Mutual Fund Complexes*, 119 U. Pa. L. Rev. 205, 253 (1970) [hereinafter cited as *Glazer*].

¹⁸³ For a discussion of economies of size see PPI, *supra* note 134, at 94-96.

¹⁸⁴ In 1962, the Wharton Report concluded that "advisory fee rates charged open-end companies by investment advisers are both significantly higher and significantly less responsive to changes in the volume of assets supervised than is the case with other client assets managed by these advisers or with open-end company assets managed internally by boards of directors or trustees." Wharton Report, *supra* note 181, at 491. In its 1966 report, the SEC noted that management fees in many cases were reduced since the Wharton Report. It noted, however, that the fees charged by advisers to many of the larger funds still did not reflect economies of size. PPI, *supra* note 134, at 102. The Institutional Investor Study found that

economies of scale exist for all types of accounts and that some savings are being passed along to the investor via lower advisory fees for larger accounts. The results show, however, that substantially greater reductions in fee ratios [1969 advisory fee divided by total account assets as of Sept. 30, 1969, with the result expressed as a percentage] exist for institutional, corporate and individual accounts.

Institutional Investor Study, *supra* note 181, at 210. For an example of a scaled-down management fee, see Fidelity Capital Fund, Inc., Prospectus 3 (March 31, 1970).

beneficial to fund shareholders in the ways described above, most studies have shown that there is no significant relationship between the size of a fund and its performance.¹⁸⁵ In fact, various commentators have noted that the larger a fund gets, the more difficult it becomes to maintain investment flexibility, which in turn may result in poorer overall management performance.¹⁸⁶ Some funds have in fact set limitations on their asset size.¹⁸⁷

The foregoing discussion briefly indicates the difficulties which the SEC or a private plaintiff suing under new section 35(b) may encounter in proving that increased fund sales compensated in part with fund assets are of little or no benefit to fund shareholders. There exists another argument, however, which may assist a plaintiff to avoid this problem. In *Moses v. Burgin*,¹⁸⁸ the court held that fund management could not use a fund asset, (recapturable fund brokerage), for the purpose of selling fund shares.¹⁸⁹ Chief Judge Aldrich based this ruling on the fund's charter, which required that the fund receive the net asset value on the sale of a fund share. The use of portfolio brokerage which could be recaptured to sell more fund shares, he reasoned, resulted in the fund's receipt of less than net asset value in the process of selling a share and also resulted in a dilution of existing shareholder interests in the fund.¹⁹⁰ The fact that in the fund manager's business judgment increased sales were of indirect benefit to the fund was, according to Judge Aldrich, irrelevant in light of the fund's charter.¹⁹¹ The use of fund assets to promote the sale of fund shares is no less a dilution of the interests of existing fund shareholders since the latter bear part of the cost of selling new shares, a cost which supposedly is to be borne, at least in the case of load funds, by the new shareholders.¹⁹²

¹⁸⁵ See SEC Institutional Investor Study, *supra* note 181, at 331; I. Friend, M. Blume & J. Crockett, *Mutual Funds and Other Institutional Investors: A New Perspective* 60 (1970).

¹⁸⁶ For a discussion of some of the problems involved in running a large fund, see Mattlin, *The Problems of Being the Enterprise Fund*, *Inst. Inv. March*, 1970, at 25; Glazer, *supra* note 182, at 254-55.

¹⁸⁷ One fund's prospectus reads: "The management of the Fund believes that attainment of its objectives will be aided by limiting its size. Accordingly, 30 days after the day when total net assets of the Fund reach \$150,000,000 the Fund will not without shareholder approval issue or sell additional shares except to existing shareholders . . . and as stock dividends and in capital gains distributions. See *Keystone Apollo Fund, Inc.*, Prospectus 4-5 (Nov. 25, 1969).

¹⁸⁸ 445 F.2d 369 (1st Cir. 1971).

¹⁸⁹ *Id.* at 374.

¹⁹⁰ *Id.*

¹⁹¹ *Id.* The management defendants had argued that even if brokerage was recapturable "the directors still had a right to choose between recapture of the give-ups for Fund's direct benefit, and awarding them to brokers for its indirect benefit." *Id.* The court held, however, that if recapture was possible, "the directors had no such choice." *Id.*

¹⁹² Former SEC Chairman Manuel F. Cohen stated that the reason § 10(d)(5) of

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The fact that there exists no charter provision of the type described in *Moses* does not foreclose the argument. Rule 22 c-1(a) under the 1940 Act provides that “[no] registered investment company issuing any redeemable security, no person designated in such issuer’s prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell . . . any such security except at a price based on the current net asset value of such security”¹⁹³ In adopting this rule the SEC stated that the purpose was “to eliminate or reduce so far as reasonably practicable any dilution of the value of outstanding redeemable securities of registered investment companies through . . . the sale of such securities at a price below their current net asset value”¹⁹⁴ Arguably, the fund receives less than the current net asset value of the sale of new shares, in violation of Rule 22 c-1 (a), to the extent that the assets of the fund are used to obtain these shares. It is unpredictable whether in such a case a court would hold, as the court did in *Moses v. Burgin*, that fund managers have no choice between using fund assets to promote sales, despite their alleged benefit to the fund, and maintaining fund assets. Another argument against the use of fund assets to pay for advertising can be raised on the ground that this use would nullify to a great extent the congressional view that investors be charged a “reasonable sales load.” If the present sales load levels were reduced but fund managers were allowed to use fund assets to pay for sales, the net effect on investors in many cases would be no change; they would continue to pay at the sale levels. However, this would seem to be contrary to the spirit, if not the letter of section 22(b) as amended in 1970. Moreover, where a fund’s prospectus sets forth a percentage sales load but fails to disclose that fund assets are used to pay for advertising, it would seem that the fund has failed to state a material fact and that what was stated in the prospectus was a misrepresentation to prospective shareholders. As the foregoing discussion shows, a fund adviser who uses

the Investment Company Act, which prohibits certain funds from using fund assets to pay promotional expenses, was passed was that “to the extent that . . . [funds] became more aggressive and they used the assets of the fund, this would be a fee paid by existing shareholders, who have very little interest or concern with whether or not other people come into the fund. . . .

[I]f you should impose that charge on the fund itself, you may be asking people who bought 10 years ago, 5 years ago, 3 years ago, to pay the part of the promotion for the benefit of the investment adviser to bring other people into the fund.” Hearings on H.R. 9510 and H.R. 9511 Before a Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 90th Cong., 1st Sess. 716 (1967) [hereinafter cited as 1967 Hearings].

¹⁹³ 17 C.F.R. § 270.22c-1(a) (1971).

¹⁹⁴ SEC Investment Company Act Release No. 5519 (Oct. 16, 1968), [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,616.

fund assets to pay for promotional activities designed to sell more shares runs a very high risk of being sued by the SEC or by fund shareholders. This is especially true in light of the First Circuit's opinion in *Moses v. Burgin*.

V. ADVERTISING AND THE DISTRIBUTION OF MUTUAL FUND SHARES

The purpose of the foregoing discussion was to indicate that the compensation received by various participants in the mutual fund distribution process has been adversely affected by past events such as the abolition of the customer-directed give-up¹⁹⁵ and, more important, that it may be further affected by future events, such as the lowering of the competitive commission rate ceiling or the establishment of a proposed national securities exchange.¹⁹⁶ The precise impact which a further decrease in the level of compensation would have depends, of course, on the extent of the decrease. Testimony before Congress in 1967 in opposition to the SEC's proposal to impose a five percent ceiling on the sales load provides an indication as to what effect a substantial decrease *might* have. In their testimony, representatives of the NASD noted the results of a 1966 survey among a random sample of 2,400 NASD members. The survey showed that if the SEC's proposals, including the five percent ceiling and the abolition of the customer-directed give-up, had been in effect in 1966, then (a) three out of five NASD members responding to the survey would have operated at a loss; (b) of the firms which had gross income of less than \$100,000, seven out of ten would have operated at a loss; and (c) of those firms which derived seventy percent or more of their income from the sale of mutual fund shares, four out of five would have

¹⁹⁵ Raymond W. Cocchi, President of the Independent Broker-Dealers Association, which, in 1969, had 391 members whose primary source of income was the sale of mutual fund shares, stated that the NYSE's abolition of the customer-directed give-up had "shut us out from a significant part of our income. . . ." See, i.e., the Hearings on H.R. 1195, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. 549 (1969) [hereinafter cited as 1969 House Hearings]. See also, Letter from Kenneth H. Sayre, Chairman of the NASD, in response to a letter from Congressman Hastings Keith, requesting information on the impact of the abolition of give-ups on members of the NASD. *Id.* at 427. The Institutional Investor Study found that the abolition of customer directed give-ups resulted in a \$15.7 million loss of income to the NYSE firms which were surveyed and which were formerly the recipients of give-ups. SEC Institutional Investor Study, *supra* note 181, at 2205-06.

¹⁹⁶ The possibility that the present level of sales loads will be reduced cannot be discounted. Although spokesmen for the SEC have stated that the Commission has no preconceived notions as to what the NASD should recommend in the sales load area, the fact remains that the basis for the SEC's original recommendation that a 5% ceiling be imposed, i.e., the differences in transaction costs, has not changed. See 1969 House Hearings, *supra* note 195, at 917-24.

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operated at a loss in 1966.¹⁹⁷ It is important to note that these figures did not include members who, although maintaining a profitable business, would have suffered a substantial reduction in profit.¹⁹⁸ In addition to these findings, the survey showed that if the five percent ceiling had been in effect in 1966 the net income, after taxes, for all the firms responding to the survey would have been reduced by 22.7 percent. It is not suggested that such drastic results would follow any reduction in present compensation levels. The survey does, however, suggest that any reduction in the current levels will affect the profitability of independent broker-dealers, especially those who engage primarily in the business of retailing mutual fund shares.¹⁹⁹

Any further reduction, however slight, will have the greatest impact on the mutual fund salesman. Typically, a beginning salesman for a firm specializing in mutual funds receives from forty to fifty percent of the sales load charged the investor. In some cases this percentage increases to approximately sixty percent as the salesman's total sales increase.²⁰⁰ Thus, if a salesman who has reached the top level of the compensation ladder (*i.e.* one who receives sixty percent of the sales load) sells \$2,000 worth of the shares of a fund that charges the typical 8.5 percent sales load, he will receive as his commission approximately \$120.²⁰¹ It must be noted, however, that, unlike a registered representative for a brokerage house who receives a portion of the commissions generated whenever one of his customers turns over his account, the mutual fund salesman receives only one commission. Of course, if he sells more shares to his existing customers, he will receive a commission on those sales. But for the most

¹⁹⁷ For the complete text of the NASD's presentation, see, 1967 Hearings, *supra* note 192, at 316-24.

¹⁹⁸ The net income of 101 responding firms whose gross income was less than \$100,000 would have been reduced by some 180%. Seventeen firms whose gross income was between \$100,000 and \$200,000 would have experienced a reduction of almost 225%. Finally, 41 firms whose gross income in 1966 was between \$200,000 and \$2.5 million would have had their net income after taxes reduced by some 28%. See *id.* at 321-22.

¹⁹⁹ The NASD survey found that 1,000 of the approximately 2,400 members surveyed retailed mutual funds as their primary activity. See *id.* at 316-24.

²⁰⁰ For an example of how such a rising scale operates, see SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 122 (1963) [hereinafter cited as Special Study].

²⁰¹ In 1966, the median dollar amount of a mutual fund purchase was only \$1,240. SEC Report on the Public Policy Considerations of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 206-07 (1966) [hereinafter cited as PPI]. A more recent survey shows that of the individuals surveyed who owned only mutual fund shares, 71% valued their investment at less than \$5,000. See Katona, Hybels and Schmiedeskamp, *Who Owns Mutual Funds? And Why? A Special Study*, Inst. Inv., Feb. 1971, at 36 [hereinafter cited as Katona].

part, a fund salesman must constantly search out new customers in order to make mutual fund selling a profitable enterprise.

Most mutual fund salesmen work on a part-time basis²⁰² and the level of their commission income reflects this fact. The SEC's Special Study, published in 1963, found that of the salesmen who worked for firms which specialized in mutual funds, sixty-seven percent earned less than \$1,000 annually in commissions.²⁰³ In contrast, only thirteen percent of the salesmen who worked for nonspecializing firms and who engaged in a general securities business in addition to selling mutual funds earned less than \$1,000 annually in commissions.²⁰⁴ The compensation of the salesmen who work full-time for an integrated organization is, as might be expected, considerably higher than that of the part-time salesman who works for a small broker-dealer specializing in fund sales. For example, in 1966 a full-time salesman for Investors Diversified Services earned, on the average, \$8,000 per annum.²⁰⁵ But it must be remembered that IDS salesmen are full-time salesmen and that therefore this \$8,000 figure represents most, if not all, of their income.

It seems clear that most mutual fund salesmen, especially those who work only part time, are not prospering by selling mutual funds. If the compensation levels are further reduced, it is likely that a good many salesmen would leave the business entirely.²⁰⁶ While it is not possible to predict accurately the ultimate effects such an exodus would have on the mutual fund industry, it is reasonable to anticipate that (a) some of the smaller independent broker-dealers, espe-

²⁰² The Special Study found that approximately two-thirds of the salesmen covered by its survey worked on a part-time basis. Special Study, *supra* note 200, at 121 n.66. The Institutional Investor Study found that 33 reporting life insurance companies had a total of 19,200 agents qualified to sell mutual funds. SEC Institutional Investor Study, *supra* note 181, at 535. Since these agents are primarily in the business of selling life insurance, they can be considered part-time mutual fund salesmen.

²⁰³ Special Study, *supra* note 200, at 121. This percentage undoubtedly would have been higher if only part-time salesmen had been considered. The study, however, included the salesmen of some fully-integrated organizations, most of whom work on a full-time basis and have substantially higher earnings.

²⁰⁴ *Id.*

²⁰⁵ See 1967 Hearings, *supra* note 192, at 475 (remarks of Mr. Robert M. Loeffler, Director and Vice-President of IDS). Approximately 70% of this income is attributable to the sale of the shares of IDS-managed mutual funds. The remainder is derived from the sale of other IDS products, such as face-amount certificates and life insurance. *Id.* at 476.

²⁰⁶ This may be true even for the full-time salesman. In his 1967 congressional testimony Robert Loeffler of IDS noted that if the SEC's proposed 5% ceiling on the sales load were adopted, the average annual compensation of an IDS salesman would drop considerably. *Id.* at 484. As it was, the turnover rate among IDS salesmen during the first two years of employment was approximately 50%. *Id.* at 493-94. The turnover rate among mutual fund salesmen as a whole is considerably high. See Special Study, *supra* note 200, at 96-98.

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cially those who concentrate on selling mutual funds, would probably go out of business because of their inability to attract a sufficient number of salesmen to generate enough sales to remain profitable,²⁰⁷ and (b) mutual fund selling would probably become more concentrated in fully-integrated organizations, large brokerage houses and, to an increasing extent, insurance companies.²⁰⁸ Although the salesmen of these organizations generally receive more commission income from selling other products, such as life insurance,²⁰⁹ they have the advantage of more customer contact and they will often be able to sell mutual fund shares as a supplement to their primary product or service.

Any substantial decrease in the number of mutual fund salesmen, especially those who work for firms which specialize in selling mutual funds, could have a serious impact upon the sale of mutual funds as a method of investment. Mutual funds, of course, will continue to be sold by registered representatives of stock exchange member firms and nonspecializing NASD broker-dealers as well as insurance agents but, as noted, the financial inducement to concentrate on selling mutual funds is hardly overwhelming.²¹⁰ It is likely, therefore, that these fund salesmen will continue to concentrate on those products and services which provide greater income for both themselves²¹¹ and their employers.²¹² The real threat to mutual fund sales

²⁰⁷ A broker-dealer who specializes in fund sales must maintain a level of fund sales which is sufficient to cover its overhead and other operating expenses. Although salesmen's income is not usually an expense since they work on a commission basis, the broker-dealer must make enough by way of his share of the sales load to cover his other expenses.

²⁰⁸ Many life insurance companies have entered the mutual fund business by way of acquisition of an existing fund management company or the creation of a new fund complex. In addition, some life insurers have executed selling agreements with unaffiliated funds. In such a case, the insurer itself or a broker-dealer subsidiary of the insurer is a member of the NASD. See SEC Institutional Investor Study, *supra* note 181, at 522-29. See also Mattlin, *New Policies for Insurance Companies: How Connecticut General is Dealing Itself into the Fund Game*, *Inst. Inv.*, Jan., 1970, at 53.

²⁰⁹ For example, a full-time life insurance agent typically receives from 75 to 80% of a year's premium on a life insurance policy issued at age 35 during the first two or three years the policy is in force. In the case of a fixed individual annuity issued at age 35, the salesman usually receives from 20 to 35% of the annual consideration paid. The 4 to 6% that a mutual fund salesman typically receives is hardly comparable. See SEC Institutional Investor Study, *supra* note 181, at 536-37.

²¹⁰ See note 202 *supra*; Special Study, *supra* note 200, at 121.

²¹¹ The Institutional Investor Study noted, for example, that "[w]hile it is difficult to evaluate agents' incentives to sell various products without being able to quantify the differences in sales effort required relative to the size of the annual premium or other payment, the magnitude of the differences in compensation for standard life insurance products as opposed to individual annuities suggests that successful life insurance salesmen are likely to continue to emphasize life insurance more than annuities (fixed or variable) or mutual funds except where special tax considerations are present. Interviews with life insurance officers confirm that this is a pervasive attitude among their more productive agents." SEC Institutional Investor Study, *supra* note 181, at 537. See also Mattlin, *New*

from the loss of what might be called the "specialist" salesman is that there would be fewer salesmen going out to spread the "mutual fund story." It is fairly well agreed that the concept of mutual funds as an investment medium must be "sold" to the investing public.²¹³ The job of the mutual fund salesmen is therefore twofold—*i.e.*, first educating the public and then selling to them. The more investors are aware of mutual funds as an investment medium, the greater the likelihood of more mutual fund sales (with the converse also being true). A recent survey conducted on behalf of the Investment Company Institute shows that seventy percent of American households surveyed were ignorant about mutual funds.²¹⁴ In addition, 58.1 million out of a U.S. Census figure of 62.9 million households did not own mutual funds.²¹⁵ The importance of fund salesmen in making people aware of mutual funds is shown by the surveys finding that present and past owners of mutual funds ranked fund salesmen second only to business and social contacts as the source from which they learned the most about mutual funds.²¹⁶ When it is considered that somewhere along the line these business and social contacts probably first learned about mutual funds from a fund salesman, the snowball effect becomes evident. That is, when a fund salesman does make a sale, he may actually be educating a number of people regarding the values of mutual funds as an investment medium.²¹⁷

This reliance on salesmen to educate the investing public in part

Policies for Insurance Companies: How Connecticut General is Dealing Itself into the Fund Game, *Inst. Inv.*, Jan., 1970, at 66.

²¹³ See Lynch, *Can the Crosby Corporation be Improved? A Case Study in the Marketing of Mutual Funds* at 55 (1968) (unpublished Advanced Study Project in the Wharton School of Commerce and Finance, Library, University of Pennsylvania).

²¹⁸ See 1967 Hearings, *supra* note 192, at 514 (remarks of Mr. Allen); University of Pennsylvania, Conference on Mutual Funds, 115 U. Pa. L. Rev. 659, 783-84 (1967) [hereinafter cited as Conference] (remarks of Mr. Grant); Funds on the Defensive, *Forbes*, Aug. 15, 1967, at 67. However, "contrary to what is often said about fund shares, no-load fund shares are 'bought' by investors rather than 'sold' to them. . . ." 1967 Hearings, *supra* note 192, at 569 (remarks of Mr. Ronald T. Lyman).

²¹⁴ ICI, Survey of the Market for Mutual Funds, April 22, 1971 at 3.

²¹⁵ *Id.* An earlier survey conducted by the Survey Research Center of the University of Michigan found that 9% of a representative sample of 4,544 family units owned mutual fund shares. Katona, *supra* note 201, at 35. Of all the security owners surveyed, 36% owned mutual funds, with 11% owning exclusively mutual funds. *Id.* at 36.

²¹⁶ ICI, Survey of the Market for Mutual Funds, April 22, 1971, at 5. In the University of Michigan Survey, the group which owned only mutual funds was asked "How did you select the mutual fund(s) you bought?" Thirty-one % mentioned a broker, 11% a mutual fund salesman and 32% mentioned someone else, primarily friends and business associates. Katona, *supra* note 201, at 38.

²¹⁷ In addition to encouraging their customers to talk to their friends and business associates about mutual funds, a salesman will often ask the purchaser to sign a "radiation card" which serves to introduce the salesman to friends and associates of the purchaser. See Special Study, *supra* note 200, at 126-27.

results from existing restrictions on advertising by mutual funds,²¹⁸ which prevents mutual funds from getting their message across to the investing public by a method other than through dealers and salesmen who sell fund shares. An easing of these advertising restrictions would produce at least two desirable results. First, more effective fund advertising could help in educating the more than fifty-eight million U.S. households unaware of the values of mutual funds as an investment medium. Second, more effective advertisements designed to inform the public about mutual funds may serve to make the selling of fund shares again a profitable business.²¹⁹ This result might obtain because a salesman hopefully would be dealing with a more aware public and he could thus concentrate his sales effort on those who have indicated an interest in mutual funds after seeing fund advertisements. Hence a salesman could probably spend less time "prospecting"²²⁰ and more time selling. Although the salesman may receive less compensation per sale, he may gain by consummating more sales.

VI. PUBLIC POLICY AND THE ADVERTISING RULES

A. *Legislative Concern*

The House Interstate and Foreign Commerce Committee, reporting on H.R. 5480 (the bill that ultimately became the Securities Act of 1933), stated that the underlying purpose of Section 10, which indicates the information required in prospectuses and Section 2(10), which defines "prospectus" to include any "advertisement . . . or other communication offering any security for sale" was

to secure for potential buyers the means of understanding the intricacies of the transaction into which they are invited. The full revelations required in the filed "registration statement" should not be lost in the actual selling process. This requirement will undoubtedly limit the selling arguments hitherto employed. That is its purpose. . . . Any objection that the compulsory incorporation in selling literature and sales argument of substantially all information concerning the issue will frighten the buyer with the intricacy of the transaction states one of the best arguments for the provi-

²¹⁸ Discussion here is limited to advertising by the mutual funds themselves and not advertising by the dealers who sell the funds. As will be noted later, there are differences in the extent to which these two groups can advertise.

²¹⁹ It is doubtful whether more effective advertising would eliminate the need for salesmen. Most people think of mutual funds as a long-term investment, similar to life insurance. This being the case, it is likely that salesmen would have to be utilized to conduct selling on a person-to-person basis. See note 208 *supra*.

²²⁰ For a discussion of "prospecting" as a technique for selling mutual funds, see Special Study, *supra* note 200, at 125-29.

sion. The rank and file of securities buyers . . . should be made aware that securities are intricate merchandise.²²¹

The congressional decision to require that offers to sell securities be made only by way of a prospectus complying with statutory requirements was based in part on a finding that during the preceding decade "[a]lluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises."²²² Although the prospectus requirements as set down in 1933 and as amended in 1954²²³ leave something to be desired regarding the delivery of a prospectus prior to sale,²²⁴ they have been effective in restricting the nature of securities advertising, including mutual fund advertising.²²⁵

²²¹ H.R. Rep. No. 85, 73d Cong., 1st Sess. 8 (1933).

²²² *Id.* at 2.

²²³ Prior to the 1954 Amendments to the Securities Act of 1933, a broker-dealer could not make a written offer to sell a security during the waiting period,—i.e., after a registration statement is filed but before it becomes effective. This was because an offer was included in the definition of sale so that a written offer during the waiting period was considered a sale which was prohibited until the registration statement became effective. In order to alleviate this situation, which prevented the desired dissemination of information concerning an issue during the waiting period, the SEC sanctioned the use of the "red herring" prospectus as well as an identifying statement, pursuant to Rule 132. In 1954, Congress specifically sanctioned the making of written offers during the waiting period while retaining the prohibition against sales until the registration statement becomes effective. For a discussion of the pre-amendment situation as well as the amendments see, S. Rep. No. 1036, 83d Cong., 2d Sess. 4-7 (1954); H.R. Rep. No. 1542, 83d Cong., 2d Sess. 4-15 (1954).

²²⁴ In addition to the dealers' examination contained in § 4(3) of the Securities Act, 15 U.S.C. § 77d(3) (1970), § 5(b)(2) of that Act, 15 U.S.C., § 77e(b)(2) (1970), requires only that a prospectus precede or accompany the delivery of a security. According to former SEC Commissioner McCormick,

[t]he prospectus has not proved to be an effective instrument for informing the public. Because of what I regard as a serious defect in the statute, most sales of new securities are being made through the use of oral communications, including interstate telephone messages, and the prospectus is being delivered only after the sale with confirmation, or the security. This is permitted by law. If the Congress believes that the investor should have certain minimum prescribed information before he purchases the security, and I think it does (certainly it is clear to me that it did in 1933 when the law was adopted), it must revise the law to see that the prospectus is delivered at a time when it can be useful to the investor in making his decision to buy, and not to be a mere memorial of [the] past transaction.

See Hearings on H.R. 7550 and S. 2846 Before the House Comm. on Interstate and Foreign Commerce, 83d Cong., 2d Sess. 71 (1954). In the case of mutual funds, the dealers' exemption does not apply. See § 24(d) of the Investment Company Act of 1940, 15 U.S.C. § 80a-24(d) (1970). It is still permissible, however, to make an oral offer and to deliver the prospectus with the security.

²²⁵ When H.R. 5480 was originally drafted, the term prospectus was defined to include any communication, oral or written, which offered a security for sale. See H.R. 5480, § 2(1), 73d Cong., 1st Sess. (Confidential Comm. Print Apr. 10, 1933). When the

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Whether the prospectus requirements, with their inherent limitation on the type of advertising permitted, were intended to apply to mutual fund shares is not clear from the legislative history of the Securities Act. But one mutual fund proponent has suggested that it is merely accidental that mutual fund shares are subject to the advertising restrictions applicable to other securities.²²⁶ He argues that an investment in a mutual fund is analogous to investment in an insurance plan, or to the offering of a full service bank, rather than to the more conventional corporate security.²²⁷ This argument is based on the view that investment in a mutual fund is really a purchase of a service—*i.e.*, professional management rather than investment in a security.²²⁸ While mutual fund shares probably were not the type of security that Congress had in mind when it formulated the prospectus requirements in 1933, there is no doubt that ample consideration was given to the mutual fund in 1940 when Congress considered methods for regulating investment companies. During this consideration Congress was aware of two pertinent facts with respect to mutual funds. First, the greater number of investment companies whose shares were registered under the 1933 Act, and which were thus subject to the prospectus requirements, were open-end management companies—*i.e.*, mutual funds.²²⁹ Second, Congress knew that prior to passage of the 1933 Act, investment companies, including mutual

bill was introduced in the House on May 3, 1933, the reference to oral communications had been deleted. See H.R. 5480, § 2(10), 73d Cong., 1st Sess. (1933). Part I of this article describes in detail how the present statutory scheme limits mutual fund advertising. See text accompanying notes 6-20 *supra*. For a discussion of how this statutory scheme has been applied to mutual fund advertising, see Mattlin, *The Trials and Tribulations of Mutual Fund Advertising*, *Inst. Inv.*, March 1971 at 21 [hereinafter cited as Mattlin].

²²⁶ See Mattlin, *supra* note 225, at 63 (statement of Nicholas G. Ciriello, Associate General Counsel of Dreyfus Corp.).

²²⁷ *Id.* It is interesting to note that the mutual fund share is compared to products and services which are specifically exempt from the registration and hence the prospectus requirements of the 1933 Act. See Securities Act of 1933, §§ 3(a)(2), 3(a)(8), 15 U.S.C. §§ 77c(a)(2), 77c(a)(8) (1964). Section 2(13), which defines "insurance company" for purposes of the 1933 Act, was amended in 1970. Act of Dec. 14, 1970, Pub. L. No. 91-547 § 27(b), 84 Stat. 1413. It is also interesting to note that reference is not made to the variable annuity, an insurance company sponsored product similar to the mutual fund, which is subject to the same limitations in advertising, since the individual annuity contracts must be registered under the 1933 Act. See *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959).

²²⁸ See Conference, *supra* note 213 at 775 (remarks of Gordon D. Henderson, Esq.). For a contrasting view of the nature of a mutual fund share, see *id.* at 776 (remarks of Richard M. Phillips, Esq.); PPI, *supra* note 201, at 76.

²²⁹ See Statement of Baldwin B. Bane, Director, Registration Division of the SEC during the Hearings on S. 3580. Hearings on Investment Trusts and Investment Companies, Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 135-36 (1940) [hereinafter cited as Senate Hearings]. See also SEC, Report on Investment Trusts and Investment Companies, H.R. Doc. No. 70, 76th Cong., pt. 2 at 755-59 (1940) [hereinafter cited as Investment Trust Study].

funds had made extensive use of advertising, in several media,²³⁰ and that the level of this advertising decreased after 1933.²³¹ If Congress did not consider the shares of a mutual fund as securities, or if it determined that the prospectus requirements as applied to mutual funds were too restrictive as regards their impact on mutual fund advertising, one would expect that Congress would have made some allowances or provided an exemption for mutual funds. It did not. In fact, Congress initially took a stronger position with respect to advertising by registered investment companies. Whereas there is no requirement that a corporation file its advertisements with the SEC at any time, Section 24(c) of S. 3580,²³² the Senate bill dealing with investment company regulation, would have prohibited a registered investment company from using any pamphlet, circular, form letter or other literature in the sale of investment company shares unless copies of the literature were filed with the SEC as part of the registration statement or as an amendment thereto. Since mutual fund shares are continually being offered, this section would have required a fund to amend its registration statement every time it changed its advertising materials. It was only after discussions between the SEC and industry representatives²³³ that this section was changed to what is today Section 24(b) of the 1940 Act, which requires that copies of all advertising and sales literature used by mutual funds be filed with the SEC within ten days after their first use or publication.²³⁴

All of these facts taken together indicate (1) that Congress was aware that mutual fund advertising was being restricted by the prospectus requirements of the 1933 Act, and (2) that Congress did not consider mutual fund shares so unique as to require more liberal treatment with respect to the advertising of those shares.

²³⁰ See Investment Trust Study, *supra* note 229, at 844-47 for examples of advertisements by open-end management companies (mutual funds). See also Supplemental Report to the Investment Trust Study dealing with Fixed and Semi-Fixed Trusts, H.R. Doc. No. 567, 76th Cong., 3d Sess. 151-56 (1940) for a description of advertisements used by fixed and semi-fixed trusts.

²³¹ See *id.* at 153 (statement of John Sherman Myers, Chairman of the Board of Distributors Group, Inc.).

²³² S. 3580, 76th Cong., 3d Sess. § 24(c) (1940).

²³³ The legislative background of the Investment Company Act is notable for the close and continuous cooperations between industry representatives and the SEC. See North, *A Brief History of Federal Investment Company Legislation*, 44 *Notre Dame Lawyer* 677 (1969); Jaretzki, *The Investment Company Act of 1940*, 26 *Wash. U.L.Q.* 303 (1941).

²³⁴ Investment Company Act of 1940, § 24(b), 15 U.S.C. § 80a-24(b) (1970). If the sponsor of the advertisement is a member of the NASD, then a copy of the advertisement must be filed with the NASD within 3 days after publication. See *CCH NASD Manual* ¶ 5002 (1971). In a bulletin dated Nov. 8, 1968, the NASD encouraged its members to file with it copies of their advertisements prior to publication.

B. SEC Enforcement of the Prospectus Requirements

In proposing to adopt Rule 134 under the 1933 Act, the SEC clearly indicated that tombstone advertisements

are intended to be limited to announcements identifying the existence of a public offering and the availability of a prospectus and they are not intended to be selling literature of any kind.

The proposed rule would . . . restrict the content of such communications to simple statements of fact identifying the security and the nature of the offering. Financial information or descriptions of the business or the security would not be included, since the amended statute [the 1933 Act as amended in 1954] contemplates that written information on such subjects will be furnished by sellers to prospective investors only by means of a prospectus meeting the requirements of Section 10.²³⁵

Whether a tombstone or any other type advertisement constitutes selling material depends upon whether it offers a security for sale. The term "offer for sale" has been interpreted broadly, consistent with the general view that the federal securities laws are to be construed "not technically and restrictively, but rather flexibly to effectuate [their] remedial purposes."²³⁶ Thus the SEC has taken the position that

the publication of information and statements, and publicity efforts, generally, made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest in the issuer or in securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of a selling effort.²³⁷

In *In re Carl M. Loeb, Rhoades & Co.*,²³⁸ the Commission stated that the terms "offer to sell" and "prospectus" "are not limited to communications which constitute an offer in the common law contract sense, or which on their face purport to offer a security. Rather . . . they include 'any document which is designed to procure an order for

²³⁵ SEC Securities Act Release No. 3535 (March 10, 1955) [1952-1956 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,333 at 79,420.

²³⁶ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963). See also SEC v. Starmont, 31 F. Supp. 264 (E.D. Wash. 1939).

²³⁷ SEC Securities Act Release No. 3844 (Oct. 8, 1957), 22 Fed. Reg. 8359 (1957).

²³⁸ 38 S.E.C. 843 (1959).

a security.'²³⁰ The courts have also liberally construed the term "offer." For example, the Court of Appeals for the Second Circuit in *Chris-Craft Industries, Inc v. Bangor Punta Corp.*²⁴⁰ held that press releases announcing that securities would be sold at some future time and containing an attractive description of the issuer's securities were offers to sell securities in violation of Section 5(c) of the 1933 Act, since a registration statement covering the securities had not been filed.²⁴¹ Although the issue of whether a particular advertisement or publicity constitutes an offer to sell a security has arisen mostly in the context of prefiling publicity, the SEC has applied the same standards to postfiling publicity. Thus, where an advertisement or other communication offers a security for sale, the advertisement or communication has been considered a prospectus as defined in Section 2(10), and, unless this "prospectus" meets the requirements of Section 10, its use by way of any of the jurisdictional means is considered a violation of Section 5(b)(1) of the 1933 Act.²⁴²

The way in which the prospectus requirements, as interpreted by the SEC and the courts, have affected mutual fund advertising is illustrated by the Commission's recent action against the American General Insurance Company and some of its subsidiaries. Although the case was settled before a trial on the merits, it provides an insight into the problems confronting mutual funds, especially those that are only part of a larger financial conglomerate. In its complaint,²⁴³ the SEC sought to enjoin American General Insurance Company (American General), Channing Financial Corporation (Channing Financial), Channing Company, Inc., (Channing Company) and the Variable Annuity Life Insurance Company (VALIC) from further violations of Section 5(b)(1) of the 1933 Act and Section 24(b) of the 1940 Act. At the time the complaint was filed, American General owned all the outstanding shares of Channing Financial, a holding company which in turn owned all the outstanding shares of Channing Company. The Channing Company was the principal underwriter and distributor of the shares issued by the Channing group of investment companies. In addition to its relationship with Channing Financial, American

²³⁰ *Id.* at 848. See also *Axe Securities Corp.*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,148; *Norman Dacey Associates, Inc.*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,816; *First Maine Corp.*, 38 S.E.C. 882 (1959); *Bankers Securities Co.*, 6 S.E.C. 631 (1940).

²⁴⁰ 426 F.2d 569 (2d Cir. 1970).

²⁴¹ *Id.* at 573-76. See also *SEC v. Arvida Corp.*, 169 F. Supp. 211 (S.D.N.Y. 1958) (by stipulation); *SEC v. Starmont*, 31 F. Supp. 264 (E.D. Wash. 1939).

²⁴² See *Axe Securities Corp.*, [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,148; *First Maine Corp.* 38 S.E.C. 882 (1959); *Bankers Securities Co. Inc.*, 6 S.E.C. 631 (1940).

²⁴³ [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,584.

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General owned, directly or indirectly, 48.9 percent of the outstanding shares of VALIC, which sponsored two registered investment companies issuing the variable annuity contracts written by VALIC.

The complaint alleged that nine advertisements which American General had caused to be published in the *Wall Street Journal*²⁴⁴ offered for sale securities of the Channing group of investment companies, as well as the variable annuities sponsored by VALIC, and that they therefore were prospectuses as defined in Section 2(10) of the 1933 Act. Since these advertisements did not contain the information as required by section 10, their publication, it was alleged, had violated section 5(b)(1).²⁴⁵ A review of the advertisements shows that only two "headlined" Channing or VALIC. One provided that "[i]t took foresight for us to move toward variable annuities 13 years ago. We are thinking of today's variables." The other read: "We have a mutual concern for the net worth of our customers. It's called Channing." A third advertisement merely mentioned the Channing mutual funds and VALIC. In the remaining six advertisements the only reference to either Channing or VALIC was the inclusion of Channing Company and VALIC in a list at the bottom of each advertisement of American General's financial service companies. The SEC alleged that all nine of the advertisements contained language which constituted an offer to sell American General securities. In addition, the SEC alleged that three of the advertisements touted particular subsidiaries of American General in an effort to sell the securities distributed by those subsidiaries. One advertisement referred to VALIC and stated, in part, that, "Valic's growth has been impressive: from \$8.1 million of annuitants' funds in 1965 to \$71.4 million at the end of 1968."

The other two advertisements referred to the Channing group of mutual funds, which were distributed by the Channing Company. One of these specified the funds and named their investment adviser:²⁴⁶ "Well known too, are the five Channing mutual funds with more than \$800 million of assets. They are managed by Channing Company, Inc. and secure their investment guidance from Van Strum & Towne, Inc."

According to the SEC, the other advertisement contained a more obvious selling effort. It provided, in part:

American General feels that there is an important place for

²⁴⁴ See 51 BNA Sec. Reg. & L. Rep., May 20, 1970, at B-7 to B-15 for reprints of the American General advertisements.

²⁴⁵ The allegation with respect to violation of § 24(b) of the 1940 Act was simply that American General had failed to file copies of the advertisements with the SEC as required by that section.

²⁴⁶ It should be noted that the naming of a fund's investment adviser is not within the scope of Rule 134. See SEC Securities Act Release No. 4709 (July 14, 1964) 1 CCH Fed. Sec. L. Rep. ¶ 1461 (1970). In addition, a statement setting forth the amount of total fund assets is not permitted under Rule 134. *Id.* at ¶ 1462.

mutual funds in a well-planned personal financial program. And we are busy adding them to the portfolios of our insurance representatives. We believe this will enable them to function as financial advisers rather than as advocates of fixed dollars only or equity dollars alone.

We were early among those many life insurance companies which became distributors of mutual funds. In 1967 First Participating Fund, Inc. came into the American General family. Early this year we acquired the adviser and national distributor of the five well-known Channing funds, with more than \$800 million of assets managed.²⁴⁷

The ad also stated that "in the field of financial services, we believe our record of foresight is impressive." The SEC charged that all the advertisements, particularly the latter three, "contribute to conditioning the public mind or arousing public interest in the issuer."²⁴⁸

As mentioned, the *American General* case was settled out of court²⁴⁹ and so there has been no determination whether any or all of the advertisements constituted an offer to sell securities. Perhaps a decision on the merits would have provided guidelines as to what constitutes conditioning the public mind or arousing public interest in securities. These guidelines would be significant with respect to mutual fund advertising since it is this standard which the SEC uses to evaluate mutual fund advertisements.

The complaint has been made that the SEC is too eager to find some conditioning influence in mutual fund advertising copy. For example, the SEC informed the Energy Fund that its use of a rocket ship pointed upward in its logo was misleading since it indicated that Energy Fund's portfolio would go up.²⁵⁰ Other examples of the SEC's strict policy include

the fund that wanted to show acorns in its logo; since acorns into great oaks grow, the logo was rejected. Another fund wanted to use a rainbow; nothing doing, because that suggested a pot of gold might be in the offing. The ICI [Invest-

²⁴⁷ SEC Securities Act Release No. 3844 (Oct. 8, 1957), 1 CCH Fed. Sec. L. Rep. ¶ 3250-56 (1971).

²⁴⁸ See note 244 supra.

²⁴⁹ See Litigation Release No. 4849 (Dec. 17, 1970). In settlement of the action, American General, without admitting the alleged violations, entered into an undertaking to comply with § 5(b)(1) of the 1933 Act and § 24(b) of the 1940 Act. One reason the defendants may have decided to settle was the fact that this suit was not the first time they had gotten into trouble for their advertisements. During 1967-68, Channing Company was warned by the Commission and the NASD's Investment Company Committee that certain of its advertisements went beyond § 2(10)(b) and Rule 134. The NASD threatened disciplinary action if there were any further violations. See Analysis, 51 BNA Sec. Reg. & L. Rep., May 20, 1970, at B-1, B-2.

²⁵⁰ See Mattlin, supra note 225, at 21.

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ment Company Institute] wanted to run an institutional ad showing a man in a rocking chair that would present the retirement benefits of mutual fund investing; the SEC said O.K. as long as the smile on the man in the chair was removed—and it was. . . . Another fund's ad was turned down simply because it used the color gold, and you know what that implies. Still another fund was told it couldn't employ a picture of its divisional office building in an ad because the building was so handsome it suggested that the fund, too, was solid and exceptional.²⁵¹

The SEC's policy with respect to mutual fund advertising copy has become more restrictive since the adoption of Rule 134 in 1955. Initially the SEC permitted a fund to use illustrations in its advertisements. In 1962, however, the Commission decided that the use of illustrations was being abused and consequently prohibited any new advertisement which contained any illustration except the fund's trademark.²⁵² This "no illustration" rule was not applied retroactively, so that some funds (Dreyfus, for example) were permitted to continue the use of illustrations and movement²⁵³ in their advertisements.²⁵⁴ Most of the funds which operate under this grandfather clause have not tried to clear new advertising with the SEC since the Commission has indicated that once a new advertisement is submitted, it will reopen the fund's entire file, review *all* advertisements previously filed, and rule on them in light of present rules and interpretations.²⁵⁵ Funds are thus reluctant to take the chance that advertisements operating under the grandfather clause may become prohibited. It appears that the SEC has gone to extreme lengths to find a conditioning influence in mutual fund advertising copy. Whether this approach is considered vigorous enforcement of the prospectus requirements or overzealous bureaucracy makes little difference to the fund manager who wants to inform the public about his product.

²⁵¹ *Id.* at 23. See generally, "Lions, Yes. Rockets, No!", *Forbes*, Aug. 15, 1971, at 49. The SEC Staff, however, has in more recent times changed some of its policies with respect to these matters. It is understood that the Staff has approved a logo with a rocket pointing upward, and that there is currently a fund which employs an acorn as its logo. Moreover, the Staff has not objected to the advertisements presently being published by the ICI which contain photographs of smiling persons who have invested in the mutual funds.

²⁵² See Perez, *A Critical Appraisal of the Marketing Structure and Techniques used in Distributing Mutual Fund Shares 138* (Ph.D. Dissertation, N.Y.U. Graduate School of Business, 1965) [hereinafter cited as Perez].

²⁵³ Movement is allowed to form the fund's logo, as in Oppenheimer's hands coming together. See Mattlin, *supra* note 225, at 68.

²⁵⁴ *Id.* See also Mattlin, *The Problems of Being the Enterprise Fund*, *Inst. Inv.*, March, 1970, at 70; "Lions, Yes. Rockets, No!", *supra* note 251.

²⁵⁵ See Perez *supra* note 252.

C. *Restrictions on Institutional Advertising*

The present restrictions on advertising by mutual funds also extend to general advertisements, by broker-dealers, designed to inform public investors of the services they provide, including the availability of mutual funds. Since broker-dealers (especially the larger brokerage firms) generally offer a number of funds, they are permitted to describe the concept of the mutual fund as an investment medium. Such generic advertising is not, however, to be used by the broker-dealer to offer for sale the securities of a particular fund. The position of the SEC with respect to this generic advertising is set forth in an opinion letter of Edward H. Cashion, former Chief Counsel of the Commission's Division of Corporation Finance, which states, in part, that:

The question of whether a particular advertisement or communication constitutes a "prospectus" as defined in Section 2 (10) of the Securities Act of 1933 depends upon the intent of the advertiser or the person transmitting such communication and the nature of the material involved. Where the purpose is to obtain purchasers for a particular security, there is an offering of that security within the meaning of Section 2 (3) of the Act, even though the name of the security is not disclosed. If, in response to inquiries, it is intended to send a prospectus relating to a specific registered security, it is apparent that the purpose of the solicitation is to obtain purchasers for such registered security. Under these circumstances, the distribution of the communication through the mails or interstate commerce results in a violation of Section 5.

The sender, of course, is the best judge of his intention in these matters. If no decision to offer specific registered securities is made until after consideration is given to the investor's circumstances, objectives and preferences and if the matter distributed does not refer to any specific security but contains only information of general interest to the investing public, [the SEC] would not be inclined to question the propriety of the advertising and distribution of this type of material. This assumes that no security is named in the communication, that the material does not indicate that it has been prepared by an issuer or a distributor of named securities and that the sender has not decided upon a specific registered security to be offered to persons who respond to the solicitation.²⁵⁶

²⁵⁶ CCH NASD Manual ¶ 5252 (1971). In *G. J. Mitchell, Jr., Co.*, 40 S.E.C. 409 (1960) the SEC held that certain generic advertisements dealing with life insurance stocks were prospectuses as defined in section 2(10), even though they did not refer to particular securities. The Commission found that the advertisements were designed to arouse the interest of prospective investors in life insurance stock generally but that in follow-up

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Thus a broker-dealer is free to advertise its offering of mutual funds generally so long as he does not intend to sell the securities of a specific fund to those who make inquiries as a result of the advertisement.²⁵⁷

Arguably, the informational function which would be served by a liberalization of the present advertising restrictions can be sufficiently served through the use of this generic advertising. It is unlikely, however, that those broker-dealers who can afford to advertise extensively the availability of mutual funds would do so since the sale of mutual funds is not likely to be the most profitable aspect of their business.²⁵⁸ And if a broker-dealer pushed the shares of a particular fund in return for portfolio brokerage, the generic advertisements might be construed to be prospectuses on the ground that the broker-dealer intended to sell the shares of a particular fund at the time the advertisement was published.

The most likely source of general information concerning the benefits of mutual fund investment is the Investment Company Institute (ICI), a trade association which represents funds holding over ninety percent of total mutual fund assets. As with broker-dealers, the ICI is permitted to sponsor generic advertising designed to inform the investing public about mutual funds as an investment medium. The advantage that the ICI has over broker-dealers is that it has no direct financial interest in pushing the securities of any particular fund. Thus the possibility that the ICI would be open to the charge that it was offering the securities of a particular fund for sale appears remote. Since 1964 the ICI has engaged in a program of generic advertising to familiarize the public²⁵⁹ with the benefits of mutual fund investment;

contact, the broker-dealer's salesmen focused on the stock in which the broker-dealer was dealing.

²⁵⁷ In order to avoid the charge that it is offering particular securities for sale in its generic advertisements, Merrill Lynch, Pierce, Fenner and Smith has agreed not to sell its own Edie Fund. See Mattlin, *supra* note 225, at 63.

²⁵⁸ See text accompanying note 219 *supra*.

²⁵⁹ The following table indicates the approximate amounts that the ICI has spent in its advertising program since 1964:

<i>Fiscal Year</i>	<i>Approximate Expenditure (000)</i>
1964	\$593
1965	438
1966	225
1967	431
1968	254
1969	370
1970	331*

Source: ICI Official

* The ICI ceased spending on advertising on June 30, 1970, and \$170,000 was carried over to fiscal 1971. The funds spent on advertising are derived from an assessment against ICI members.

as its recent survey indicates,²⁶⁰ however, the results have not been gratifying.

D. *SEC Proposals to Change the Advertising Rules as They Relate to Investment Companies*

On December 1, 1971, the SEC released for public comment a number of proposed changes relating to investment company advertising.²⁶¹ The changes would be effected by amending Rule 134 to provide greater latitude in tombstone advertisements, by adding a new Rule 135A, and by amending Rule 434A to permit registered investment companies to use a summary prospectus.²⁶² In its release announcing the proposed rule changes, the SEC acknowledged the frequent complaint that "a tombstone advertisement accomplishes nothing because many persons do not even know what a mutual fund is."²⁶³ It is in response to this complaint that the SEC proposes to amend Rule 134 to permit in a tombstone advertisement "a general description of an investment company, its general attributes, method of operation and services offered, provided the description is not inconsistent with the operation of the particular fund mentioned in the tombstone advertisement."²⁶⁴

In addition to reference to the general attributes of a particular fund, the amended rule would permit advertisements that contain offers, descriptions and explanations of products and services which do not constitute securities to be combined with a tombstone advertisement relating to the securities of an investment company.²⁶⁵ This combined advertising would be permitted only on condition that the nontombstone portions of the advertisement "do not relate directly to the desirability of owning or purchasing a security,"²⁶⁶ that the tombstone portion of the advertisement otherwise complies with Rule 134, and that it be segregated in an enclosed area in the advertisement. On the surface this proposed change appears to cover the advertisements published by the American General Insurance Co., previously discussed in detail. It must be remembered, however, that American

²⁶⁰ See text accompanying notes 213-17 supra.

²⁶¹ SEC Securities Act Release No. 5213 (Dec. 1971), [Current] CCH Fed. Sec. L. Rep. ¶ 78,433 (1972).

²⁶² Presently, registered investment companies cannot use a summary prospectus since Form S-5, the form used by such investment companies to register securities under the Securities Act, does not provide for a summary prospectus. Under Rule 434A, use of a summary prospectus is allowed only if, inter alia, "the form used for registration of the securities to be offered provides for the use of a summary prospectus. . . ." 17 C.F.R. 230.434A (1971).

²⁶³ [Current] CCH Fed. Sec. L. Rep. ¶ 78,433 at 80,951 (1972).

²⁶⁴ *Id.*

²⁶⁵ *Id.*

²⁶⁶ *Id.*

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General was charged with offering securities for sale through its advertisements. There is nothing in the proposed amendments to Rule 134 which would permit an investment company to use advertising as a selling device. Thus it is not clear whether American General would have been sued had the proposed rule changes been in effect.²⁶⁷

Changes with respect to generic advertising are also contemplated in the proposed rule changes. Under proposed Rule 135A, a broker-dealer, including one who underwrites a particular fund, would be permitted to advertise generically investment company securities so long as a particular security is not named in the advertisement.²⁶⁸ This rule is a departure from the SEC's long held position that a broker-dealer who underwrites or sponsors a particular security presumably intends to sell that security and therefore is not permitted to utilize generic advertising since such an advertisement would be considered a prospectus. Proposed Rule 135A would limit the contents of generic advertisements

to explanatory information relating to the nature of, and services offered by investment companies generally, the mention or explanation of investment companies of different generic types, and offers, descriptions and explanations of products and services not constituting securities which do not relate directly to the desirability of owning or purchasing a security ("combined" advertising). The advertisement or other communication could contain an invitation to inquire for further information and would be required to state the name and address of the broker, dealer or other person sponsoring the communication.²⁶⁹

In addition to the above information, a generic advertisement would have to include the name of a particular security if, during the previous calendar year, thirty percent or more of the advertisement sponsor's sales of total mutual fund sales involved the securities of one fund or complex of funds. Further, the sponsor would be required to state in the advertisement either the approximate percent of its sales of the securities of that particular fund relative to its total fund sales or, if the sponsor did not wish to disclose the percentage, he could simply identify the securities of the fund in which he specialized, state his relationship with the issuer and state that he sold or sponsored the named security.²⁷⁰ The purpose of this requirement is to give notice to the investor who reads a generic advertisement that its sponsor has an interest in selling the securities of a particular fund

²⁶⁷ See Phillips, *Mutual Fund Advertising*, Rev. of Sec. Reg., at 980 (Feb. 4, 1972).

²⁶⁸ [Current] CCH Fed. Sec. L. Rep. ¶ 78,433 at 80,952 (1972).

²⁶⁹ Id. Sec proposed Rule 135A (a)(1)-(4), (6). Id.

²⁷⁰ See proposed Rule 135A. Id.

and, more important, that the sponsor sells the securities of other funds.²⁷¹

It is unclear from the SEC's release whether Rule 135A completely abrogates the Cashion opinion. A literal construction of the proposed rule would seem to permit a broker-dealer to publish a generic advertisement even though at the time of publication the broker-dealer intends to sell the securities of a particular fund; only those broker-dealers whose sales of a particular fund during the prior calendar year exceeded thirty percent of their total fund sales would be required to disclose the name of the security and their relationship with the issuer. Under this literal reading of proposed Rule 135A, the Cashion opinion clearly can no longer be considered the policy of the SEC. The proposed rule can, however, be construed simply as eliminating the presumption that the underwriters and sponsors of fund securities intend, at the time their generic advertisement is published, to sell the securities of the fund or funds they underwrite or sponsor. Under this construction, a broker-dealer who, at the time he publishes a generic advertisement, *actually* (rather than presumably) intends to sell the securities of a particular fund may be deemed to have offered a particular security for sale by way of the generic advertisement. This interpretation of proposed Rule 135A is consistent for the most part with the Cashion opinion. If the SEC adopts these advertising rule changes it should clearly indicate its interpretation of proposed Rule 135A.

Perhaps the most far-reaching change effected by the proposed rules is the one which would permit investment companies to use a summary prospectus. Under the proposed changes, Rule 434A²⁷² would be amended to permit expressly the use of a summary prospectus by *registered* investment companies. Form S-5, the form used by registered investment companies to register their securities under the Securities Act of 1933, would also be amended to indicate that a summary prospectus may not be used

unless a registration statement under the Securities Act of 1933 is in effect, or if at the time of its use the registrant has had a prior history of operations other than that of an investment company during the past five years or if certain specified transactions with affiliates have occurred during the past three years, or if at that time the registrant does not intend

²⁷¹ Rule 135A would also require that the sponsor of an advertisement have available for sale the type of security, service or product described in the advertisement. *Id.* at 80,952.

²⁷² 17 C.F.R. § 230.434A (1971).

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to meet the requirements of Subchapter M of the Internal Revenue Code.²⁷³

A summary prospectus under the proposed rule changes would include "a brief statement of the investment objectives of the registrant which statement shall not be inconsistent with the statement as to investment objectives contained in the prospectus included in the registration statement."²⁷⁴

In addition, the summary prospectus would include certain of the information contained in Form N-8B-1,²⁷⁵ regarding specific activities of the fund, if the fund has an affirmative policy with respect to these activities.²⁷⁶ On the outside front cover of the summary prospectus the registrant must state clearly (1) the maximum sales load expressed as a percentage of the public offering price per share; (2) any redemption or repurchase charge; and (3) a legend in bold-face type urging all interested persons to send for and examine the full statutory prospectus before purchasing the shares of the fund.²⁷⁷ The proposed amendment also provides that the registrant may request that certain information be omitted from the summary prospectus and that the SEC "may . . . require the inclusion of other information in addition to, or in substitution for, the information [already] required in any case where such information is necessary or appro-

²⁷³ [Current] CCH Fed. Sec. L. Rep. ¶ 78,433 at 80,953 (1972).

²⁷⁴ See proposed addition to Form S-5. Id. at 80,954.

²⁷⁵ Form N-8B-1 is the form prescribed by the SEC for the registration statements of management investment companies. See 3 CCH Fed. Sec. L. Rep. ¶ 51,293.

²⁷⁶ For example, the registrant's policy with respect to the borrowing of money, the underwriting of securities of other issuers, the concentration of investment in particular industries, the purchase and sale of real estate, the purchase or sale of commodities or commodity contracts and the making of loans to other persons need not be set forth in the summary prospectus unless the registrant has an affirmative policy to engage in such activities. See [Current] CCH Fed. Sec. L. Rep. ¶ 78,433 (1972). As Form N-8B-1 now exists, a registrant must set forth in Item 4 of the form its policies with respect to the above and other activities whether or not they constitute affirmative policies. In addition, the registrant may under the proposed rule exclude from the summary prospectus certain of the information required to be stated in Item 5 of Form N-8B-1. For example, the registrant need not state the percentage of its assets which are permitted to be invested in any other issuer (except government securities) unless that percentage exceeds 5% of its assets; it need not state the percentage of voting securities of any one issuer which it may acquire unless that percentage exceeds 10%; it need not state its policy with respect to investment in the securities of other investment companies unless it is permitted to invest more than 5% of its assets in such other investment companies; it need not state its policy with respect to investing in companies for the purpose of exercising control unless it is permitted to do so and it need not disclose its rate of portfolio turnover unless it has averaged over 75% for the past three years. Id.

²⁷⁷ Id. at 80,953-54. The proposed instructions to Form S-5 would make clear that no sales literature may be used unless preceded or accompanied by a full statutory prospectus.

appropriate for the protection of investors."²⁷⁸ The purpose of this provision is to require disclosure of adverse facts which would differentiate the fund from the typical mutual fund.²⁷⁹

Although a fund is not permitted to include financial statements or lists of investments in the summary prospectus, it is required to include information with respect to per share income and capital changes covering the previous ten years of operation or the total number of years that the fund has been in existence if less than ten.²⁸⁰ Among the capital changes required to be stated are the changes in net asset value and changes in net realized and unrealized profits (and losses) on securities. In addition, the ratio of operating expenses to average net assets, the ratio of net income to average net assets and the number of shares outstanding must be stated.²⁸¹ Although inclusion of this information in a summary prospectus may not satisfy fund managers who might wish to publicize their performance records,²⁸² it does provide investors a basis for comparing the growth records of different funds having the same investment objectives.²⁸³

The value of a summary prospectus to a mutual fund is in its use as an advertisement. Under existing restrictions, which allow only the use of the full statutory prospectus, the cost of printing a full prospectus and using it as an advertisement is prohibitive.²⁸⁴ Such may not be the case if mutual funds can use a summary prospectus, especially where the particular fund lacks affirmative policies with respect to the activities described in Form N-8B-1 and thus could exclude

²⁷⁸ *Id.* at 80,954.

²⁷⁹ *Id.* at 80,953.

²⁸⁰ This information is the same as that required by Item 12 of Form N-8B-1. The proposed amendments to Form S-5 would require that this information be set forth not further back in the summary prospectus than the third page thereof and that it not be preceded by any other chart or table.

²⁸¹ See Item 12(a) of Form N-8B-1, 3 CCH Fed. Sec. L. Rep. ¶ 51,293 at 39,255.

²⁸² Even if publication of performance records is not considered an attempt to sell the securities of a fund, it could be argued that it is misleading and violative of the antifraud provisions of the federal securities laws if performance was measured on other than a risk-adjusted basis. For a discussion of performance standards in the context of incentive fee arrangements, see H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 263-65 (1971) [hereinafter cited as SEC Institutional Investor Study]. Indeed, it has been suggested that the per share income and capital change table which would be permitted under the proposed rules would be misleading unless per share data are risk adjusted. See 137 BNA Sec. Reg. & L. Rep., Feb. 2, 1972, at A-11, A-12.

²⁸³ Fluctuation in the value of portfolio securities as well as fund sales (including reinvestment) and redemptions are the basic determinants of a fund's net assets. A table which shows changes in net assets indirectly indicates the fund's performance both in the context of changes in the value of portfolio securities and in sales of fund shares. It has been found that on a cumulative basis, performance is followed by increased cash inflow (sales). H.R. Rep. No. 2274, 87th Cong., 2d Sess., 343-44 (table V-19b) (1962) [hereinafter cited as Wharton Report].

²⁸⁴ The Dreyfus Fund, however, has printed its full prospectus as a supplement to the Sunday New York Times.

reference to such activities in its summary prospectus. It remains to be seen whether funds, particularly the smaller ones, would determine that the possibility of increased sales to be derived from publishing a summary prospectus as an advertisement outweighs the costs involved.

E. *Some Additional Proposals*

In the Survey of Mutual Fund Investors conducted by the Securities Research Unit of the Wharton School of Finance and Commerce for the Special Study,²⁸⁵ it was noted that:

[T]he generally low level of knowledge displayed by most mutual fund investors regarding their funds is one of the most significant findings of the survey. . . . On the average, slightly over an hour was devoted to reading the prospectus, and often little of its contents was retained. Knowledge of sales charges and sources of funds' earnings was frequently inadequate, and knowledge of the expenses for fund operations was negligible. It might be observed that although the typical prospectus provides much of the relevant information necessary to appraise fund operations, its complexity, legal tone, and lack of explanations and clarifications limit its effectiveness for the average investor. In addition it should be noted that the prospectus gives no comparative data relating to fund performance. Thus, there may be a considerable gap between a document which satisfies the requirements of legal disclosure and one which promotes effective understanding.²⁸⁶

It is clear from this statement that the statutory prospectus delivered to the average mutual fund investor does not greatly enhance his knowledge of his investment. Since the summary prospectus would contain less information, it is not likely that its use would lead to greater investor knowledge of his investment.²⁸⁷ The essential fact which an investor would like to know about a particular fund is how it has performed relative to other funds having the same investment objective. A summary prospectus which otherwise complies with proposed rule changes should also be *required* to contain information with respect to a fund's performance over a given period.²⁸⁸ Such

²⁸⁵ SEC, Report of the Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. 265, app. XI-A (1963).

²⁸⁶ *Id.* at 347-48.

²⁸⁷ Use of a summary prospectus in no way dispenses with the obligation to provide an investor with the statutory prospectus before any other sales literature is provided. See note 277 *supra*. Knowledge of the operations of a particular mutual fund is to be distinguished from awareness of mutual funds generally as an investment medium.

²⁸⁸ It is essential that funds be required to include this information—otherwise funds having poor performance records would not be inclined to include it.

information should be presented on a standardized basis, including adjustments for the risk assumed by the managers of the fund.²⁸⁹ In addition to the inclusion of these risk-adjusted performance figures, the summary prospectus should indicate that there exist other funds having the same investment objectives. This disclosure hopefully would induce an investor to inquire into these other funds to compare their performance.

Coupled with this use of a summary prospectus should be an effort to make the statutory prospectus more readable to the average investor. The SEC has already proposed the adoption of changes in this direction.²⁹⁰ In addition, either the Securities Act or the Investment Company Act should be amended to *require*, in the case of investment company securities, the delivery of the statutory prospectus *prior* to consummation of the sale²⁹¹ so as to give an investor time to digest the information contained therein and to compare funds which have the same investment objectives. An exception to this requirement can be made in the case of an unsolicited order, since it can reasonably be assumed that the investor is already familiar with the fund. A statutory prospectus should, however, accompany the security. The above recommendations are consistent with the general policy of disclosure underlying the Securities Act. Although the use of performance statistics may be considered a selling effort,²⁹² it may also be considered a form of disclosure which, when combined with a more readable statutory prospectus, may lead to a better informed mutual fund investor.

²⁸⁹ See note 282 *supra*. For a discussion of the beta coefficient which is the standard risk measure see, I. Friend, M. Blume & J. Crockett, *Mutual Funds and Other Institutional Investors: A New Perspective* 54-55 (1971); Oberg's Critique: Beta in Investment Portfolios, *Weekly Bond Buyer*, Jan. 3, 1972, at 11. Cf. SEC Institutional Investor Study, *supra* note 282, at 264-65.

²⁹⁰ See SEC, Securities Act Release No. 5164 (July 16, 1971) [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,152. In a related move, the SEC has decided to permit the use in a prospectus of photographs of a registrant's management, principal properties and principal products so long as use of such photographs is not misleading. See SEC, Securities Act Release No. 5171 (July 20, 1971) [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,155.

²⁹¹ Under existing law (§ 5(b)(2) of the Securities Act, 15 U.S.C. § 77e(b)(2) (1970)), a statutory prospectus must precede or accompany the delivery of a security. The Survey of Mutual Fund Investors found, however, that 20% of the mutual fund investors surveyed indicated that they had never received a prospectus. See Special Study, *supra* note 285, at 297-98, app. XI-A.

²⁹² The major objection to the use of performance figures is that they may mislead a naive investor to believe that similar performance would be obtained in the future. To the extent that this performance may not be obtained, it is similar to a corporation projecting what its earnings will be at some future time. In this latter regard, SEC Chairman Casey has indicated that the current restrictions on earnings projections should be reconsidered in light of practical realities. See *Wall Street Journal*, Nov. 19, 1971, at 6, col. 3-4. See also Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Re-examine Policies Against Permitting Projections*, 40 *Geo. Wash. L. Rev.* 222 (1971).

F. *Impediments to the Expanded Use of Advertising by Mutual Funds*

If the SEC proposals regarding advertising by mutual funds are adopted and if, as a result, mutual funds determine to increase their advertising expenditures, the question arises as to who will bear the burden of these increased expenditures. The observations previously made with respect to possible sources of additional compensation for those who sell mutual fund shares²⁰³ are equally applicable here; the only difference is that here the increased expenditures would be for advertising rather than for direct compensation of the participants in the mutual fund distribution chain. As noted previously, there exist three possible sources of additional compensation which can also be the source for funds to be used for advertising. These are the sales load, the fund's adviser and the fund itself—*i.e.*, the fund's shareholders. As was also noted, there are obstacles which may prevent the utilization of any one or all of these sources.

Although an increase in the sales load appears to be the most equitable source, since the cost of advertising would be borne by incoming shareholders rather than existing shareholders, there is, as was previously noted,²⁰⁴ some indication that Congress expected the sales load to be reduced. If this in fact is the case, then it is unlikely that sales loads would be permitted to be increased to cover the cost of advertising, especially if there are no demonstrable benefits to those fund shareholders who are paying for it. The payment of advertising expenses by a fund's adviser or underwriter does not appear to present any problems so long as these costs are not passed on to fund shareholders, for example, by changing the method of calculating the management fee to increase each of the fund investor's proportionate cost for management.²⁰⁵ It is strictly a business decision whether or not to spend money on advertising,²⁰⁶ but the money spent should be the adviser's and not that of the fund shareholders.²⁰⁷

The most direct source of payment for advertising is the fund itself, which realistically means the fund's shareholders. As previously noted, a fund adviser which uses fund assets for promotional purposes runs a substantial risk of being sued on the ground, among others, that

²⁰³ See discussion at pp. 983-94 *supra*.

²⁰⁴ See discussion at p. 985 *supra*.

²⁰⁵ For example, the management fee could be raised from the typical one-half of 1% of net asset value to five-eighths of 1% of net asset value.

²⁰⁶ The primary benefit which increased advertising would produce is, of course, increased sales, which in turn would result in increased net assets, and in most cases, an increase in the management fee received by the fund's adviser.

²⁰⁷ For a discussion of the legal problems which may confront an adviser who pays for advertising but then passes the cost on to fund shareholders, see pp. 986-88 *supra*.

it had failed in its fiduciary duty to fund shareholders.²⁹⁸ And even if the benefits derived from this promotion are passed on to the fund's shareholders, a fund adviser may find itself in the same position as the adviser in *Moses v. Burgin* with respect to the use of fund assets to promote sales.

As the foregoing discussion indicates, the fact that existing restrictions on mutual fund advertising may be liberalized does not necessarily mean that all mutual funds will increase their expenditures for advertising. One reason is that it cannot be predicted whether increased advertising within the limits of the rule changes proposed by the SEC will result in increased sales. However, even if it is assumed that an increased advertising effort would in fact result in increased sales, the question arises as to who will pay for this advertising effort. The answer to this question is not at all clear.*

CONCLUSION

The recent proposals by the SEC to liberalize somewhat the restrictions on mutual fund advertising are not only desirable but essential if mutual funds are to continue to be a viable investment medium, especially for small investors. This is especially true since recent developments in the securities industry, such as negotiated rates or the proposed prohibition of reciprocal practices, which are almost universally used by fund managers to induce the sale of their fund's shares, may have a severe impact upon the traditional methods of distributing fund shares. Increased mutual fund advertising may lessen this impact in that those who sell mutual funds might have to spend

²⁹⁸ See discussion at p. 990 supra.

* On May 9, 1972, the SEC announced the adoption of rule changes relating to investment company advertising. Securities Act Release No. 5248. Although these changes for the most part are the same as those proposed in Securities Act Release No. 5213 (Dec. 1, 1971), some modifications have been made and in some cases the scope of the rules as proposed was clarified. For example, the release makes clear that the Staff's position with respect to generic advertising as expressed in the Cashion opinion is no longer the position of the Commission. In addition, the Commission considered the percentage test embodied in the proposed rules unworkable and substituted a requirement that if an advertisement for investment company securities solicits inquiries and if in response to such inquiries a prospectus is to be sent, the advertisement must state "the number (and not the names) of such investment companies, and, if applicable, the fact that the sponsor of the communication is the principal underwriter or investment advisor in respect to such investment companies. . . ." Although the modifications and clarifications made by the Commission are important, the most significant statement in the release announcing the rule changes was that:

The Commission considers the new provisions to be a modest step in the direction of liberalizing the rules relating to advertising for investment company securities. . . . It is anticipated that . . . further rules dealing with investment company advertising will, at a later date, be noticed for comment by interested persons.

It is thus apparent that the Commission has only just begun.

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less time educating the investing public regarding the value of mutual funds as an investment medium, thereby spending more time actually selling fund shares. Any loss of income occasioned by these developments may be offset by the income received because of increased sales. In addition, more effective mutual fund advertising may reduce reliance on individual salesmen. If the SEC's proposed rule changes were adopted, thus permitting more effective advertising by mutual funds, questions arise as to whether funds in general would increase their advertising expenditures and, if so, as to who would bear the burden of these expenditures. The first question is unanswerable because it cannot be predicted whether mutual funds will decide that the potential benefits to be derived from increased advertising would exceed the burdens—*i.e.*, the cost. If funds, however, do decide to advertise extensively, it would seem that the expenditures involved should be borne by the fund adviser or underwriter, to the extent that no demonstrable benefits accrue to fund shareholders.

INSTITUTIONAL MEMBERSHIP AND THE EXPERIENCE OF THE PHILADELPHIA- BALTIMORE-WASHINGTON STOCK EXCHANGE

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On February 4, 1972, the Securities and Exchange Commission (SEC) issued a policy statement in the form of a special report entitled "Future Structure of the Securities Markets."¹ The policies announced in the report were designed to secure "three paramount objectives"² as a means of enabling the securities industry to "perform an even more vital function in the economy of our country."³ The first objective was "to make the relationships in the securities market and their operation as simple, as direct, and as open"⁴ as possible. To this end, the SEC has proposed a more competitive market structure which would compel brokers to discard reciprocal, relative and recapturing practices and thereby to become more investor-oriented.⁵

The second objective was "to adapt the securities markets to growing institutionalization . . . while maintaining the confidence and the participation of the individual investor."⁶ The SEC envisions a single "central market system" as the most efficient and effective means of achieving this objective.⁷ Such a system is intended to centralize

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¹ SEC Policy Statement, Future Structure of the Securities Markets, (Feb. 1972) [hereinafter cited as SEC Policy Statement].

² Id. at 2.

³ Id. at 1.

⁴ Id. at 2.

⁵ Id. at 2-3. A "reciprocal" has been described as "an arrangement whereby, at the discretion of a customer or fund manager, the executing broker rewards a broker who has no role in connection with the execution of the transaction by furnishing him with unrelated business . . . designed to produce a specific level of commission. . . ." Miller & Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U. L. Rev. 35, 36 n.6 (1971) [hereinafter cited as Miller & Carlson].

A rebate occurs "[w]hen an executing broker at the direction [and for the benefit] of his customer [typically an investment adviser for a mutual fund or other type of financial institution] gives up part of the commission to another broker who has not participated in the transaction." *Moses v. Burgin*, 445 F.2d 369, 372 n.4 (1st Cir. 1971).

Recapture is the recovery of a portion of the executing broker's commissions for the direct benefit of the institutional investor. See Miller & Carlson, *supra*, at 55-71.

⁶ SEC Policy Statement, *supra* note 1, at 3.

⁷ Id. at 7-12. The SEC describes its proposed central market system as "a system of

the buying and selling of all listed securities and to facilitate the realization of the first objective—simple, direct and open relationships and operations. The SEC believes that a central market system would both strengthen the market, in order that it may better cope with the growing volume of institutional trading, and make the investing public aware of competition among the separate exchange markets, including listed stock prices and trade volumes.⁸

The final objective was to make "the professional service available to investors as efficient[ly] and economic[ally] as possible without diluting standards of service and responsibility."⁹ To achieve this result, in light of the desired regulatory uniformity of a single central market system, the SEC has endorsed a limited form of membership on all stock exchanges for institutional members—broker-dealer affiliates of mutual funds and other institutional investors. More specifically, the brokerage subsidiaries of institutional investors would be required to conduct a "predominant portion" of their brokerage commission business for nonaffiliated sources.¹⁰

The SEC's opposition to unrestricted institutional membership is in large measure a response to the practice whereby institutional investors use their affiliated membership on an exchange "primarily as a vehicle for obtaining recapture of commissions."¹¹ William J. Casey, Chairman of the SEC, has stated that the Commission believes that it "is harmful to public confidence and to the kind of professional responsibility which should characterize our securities markets for brokerage firms to have the privilege of exchange membership without the obligation, the responsibility and primary purpose of serving a sector of the public other than their own affiliates."¹² However, this position ignores the fact that millions of individuals invest their savings in institutional pools of capital, and that these investors constitute a significant "sector of the public" which is served by affiliated brokers. In addition, the recent decision in *Moses v. Burgin*¹³ indicates that money managers owe a fiduciary duty to institutional shareholders that requires managers to effect commission savings or to recapture commissions.

communications by which the various elements of the marketplace . . . are tied together. It also includes a set of rules governing the relationships which will prevail among market participants." *Id.* at 8.

⁸ *Id.* at 7-12.

⁹ *Id.* at 4.

¹⁰ *Id.* at 53-54. The SEC stated that "[p]redominant means . . . significantly more than half." *Id.* at 54. More recently, the Commission has indicated that "predominant" means "significantly more than two-thirds" and possibly as much as 90%. The New York Times, Feb. 6, 1972, § 3 (Business and Finance), at 9, col. 2.

¹¹ SEC Policy Statement, *supra* note 1, at 48.

¹² New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2, cols. 2-3.

¹³ 445 F.2d 369 (1st Cir. 1971).

INSTITUTIONAL MEMBERSHIP AND THE P-B-W

If implemented, the SEC policy of restricted institutional membership will have a major impact on regional stock exchanges which presently allow affiliated brokerage membership.¹⁴ The Philadelphia-Baltimore-Washington Stock Exchange (P-B-W) would be one of the most significantly affected regional exchanges since affiliated broker-members account for approximately fifty per cent of its business. In effect, the regional exchanges would have to adopt restrictive admissions requirements. On the other hand, the American and New York Stock Exchanges, which prohibit institutional membership, would have to broaden their admissions rules in order to comply with the SEC's policy.¹⁵

Since publication of the SEC's special report announcing the Commission's policy on institutional membership, a growing unrest, headed by the P-B-W, has developed among many regional exchanges.¹⁶ Convinced that any benefits to be derived from restricting institutional membership would be speculative and remote, the P-B-W has reaffirmed its policy of unrestricted membership for broker-dealers affiliated with mutual funds and other institutional investors.¹⁷ Some regional exchanges, notably the Midwest, Pacific Coast and Boston exchanges, have "expressed reservations about the Securities and Exchange Commission's institutional-membership plan [and] have been threatened with antitrust suits from concerns that would lose their membership if the eligibility rules were tightened."¹⁸ Other exchanges which appear to have acquiesced to the SEC's plan have indicated that they will implement that policy only after being assured that all exchanges will cooperate simultaneously.¹⁹

This article will discuss the P-B-W's experience with institutional

¹⁴ In addition to the Philadelphia-Baltimore-Washington Stock Exchange (P-B-W), other regional exchanges which presently have institutional members include: the Midwest Stock Exchange (MWSE), the Pacific Court Stock Exchange (PCSE), and the Boston Stock Exchange (BSE). The Cincinnati Stock Exchange does not have any institutional members, but its rules do not prohibit such membership. *Wall Street Journal*, March 2, 1972, at 2, cols. 3-4.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*, Feb. 10, 1972, at 2, col. 2.

¹⁸ *Id.*, March 2, 1972, at 2, col. 3. In response to a statement by SEC Chairman William J. Casey that institutional members should be required to conduct approximately 80% of their brokerage business with unaffiliated public investors, MWSE President Michael Tobin stated that this percentage was unnecessarily high for protecting public investors: "A figure as high as 80% would . . . not only be unduly restrictive in admitting new members but might cut out a considerable number of existing, traditional members that are basically brokerage houses but have created their own mutual funds or have emphasized advisory or management services." *Id.*

Thomas P. Phelan, President of the PCSE, stated that "the commission's proposals may have very serious anti-competitive effects, and we plan to examine this matter very closely and on a continuing basis." *Id.*

¹⁹ *Id.* at 2, col. 3.

membership. The advantages of broker-affiliated membership and an analysis of the arguments against institutional membership will then be examined in light of the recent SEC policy statement. Finally, it will be concluded that the continued growth of unrestricted institutional membership is in the public interest and that it will serve to strengthen the public securities market.

I. THE P-B-W'S EXPERIENCE WITH INSTITUTIONAL MEMBERSHIP

A. *Background*

The P-B-W is a national securities exchange which permits the membership of brokerage subsidiaries of institutional investors. Although the constitution of this Exchange states that member organizations must be principally engaged in the business of a broker or dealer in securities, this requirement refers only to the member and not to its parent affiliation.²⁰ In short, the P-B-W has no rules which prohibit institutional membership.

In December of 1967, the P-B-W claimed a total of 167 member organizations, of which four were affiliated with institutions. In 1968, the Exchange began admitting institutional affiliates in significant numbers; at present it has 317 member organizations, of which forty-five are broker subsidiaries of institutional investors. These affiliates were admitted because they satisfactorily met the P-B-W's eligibility standards, which require that the applicant (1) be financially responsible; (2) be run by professionally competent and experienced personnel; and (3) be associated only with persons of integrity who comply with the letter and spirit of the rules governing the Exchange.²¹

Unrestricted admissions requirements have been the primary factor in the increased number of institutional members in the P-B-W; in turn, this membership has substantially contributed to the growth of the Exchange and to its strength as an independent, competitive marketplace. In fact, from 1960-69, "[m]ost of the growth in the securities industry . . . was due to [an] increase in securities transactions by institutional investors. Moreover, since the average price of shares traded by institutions has always been higher than the average price of shares traded by individuals, the institutions accounted for an even higher proportion of the dollar volume on all exchanges."²² Institutional members on the P-B-W presently execute approximately one-half of the orders transacted on the Exchange. As the institutional

²⁰ P-B-W Constitution, art. XIV, § 2.

²¹ P-B-W Constitution, art. XI, § 6.

²² SEC, Institutional Investor Study Report of the Securities and Exchange Commission, pt. IV, at 2311-12 (1971) [hereinafter cited as SEC Institutional Investor Study].

volume handled by these members has grown, there has been a corresponding enhancement in the ability of broker-affiliates to find purchasers or sellers for incoming orders on the floor of the Exchange. The result has been a substantial improvement in the ability of Exchange members to execute noninstitutional orders, which has led to the development of a willingness on the floor of the Exchange to position securities at risk. As a consequence of the P-B-W's growth and improved competitive position, the Exchange has been better able to serve directly the needs of sound but small broker-dealers unable to afford membership on the New York Stock Exchange (NYSE) and, indirectly, to serve the small individual customers of such firms.

B. *Capitalization*

Institutional membership on the P-B-W has also mitigated the effects of a problem currently plaguing the securities industry—undercapitalization. It has been observed that:

“Capital” in the securities industry often takes the form of subordinated customers’ accounts and volatile securities (used for speculative purposes) rather than liquid funds that would be fully available in a financial crisis.

Capital structures built on such an insubstantial base were strained by the firms’ increasing need for funds. Members required capital not only to finance expansion of volume but also to obtain computers to service the increased volume and . . . to position blocks of securities.²³

The capital committed by the institutional membership of the P-B-W, which exceeds fifty million dollars, is dedicated almost exclusively to broker-dealer activities, unlike that of many noninstitutional affiliates who, with increasing frequency, devote their capital to a multitude of nonsecurities activities. For example, many of the latter brokerage houses are “attempting to diversify into asset management. Like banks, some want to move into every aspect of investment and financial services.”²⁴

As a group, the institutional membership of the P-B-W operates under an aggregate indebtedness amounting to two to three times their net capital. Roughly translated, this fact means that these institutional members carry an aggregate indebtedness ranging between one hundred and one hundred fifty million dollars. This situation presents no real cause for concern since the institutional members of the P-B-W are in a better position to meet additional capital requirements than

²³ Carey & Werner, *Outlook for Securities Markets*, Harv. Bus. Rev. 17-18 (July-Aug. 1971) [hereinafter cited as Carey & Werner].

²⁴ *Id.* at 18.

most unaffiliated broker-dealers. The typical P-B-W institutional member has as part of its corporate complex a large parent corporation with ample funds to increase the capital of its affiliated member firm as the need occurs. By contrast, the typical nonaffiliated broker-dealer depends on much less accessible sources for capital—*i.e.*, the money of principals, subordinated private lenders and the public. The capital of nonaffiliated brokers would be strained to the breaking point if such members had to absorb an indebtedness proportionally comparable to that of institutional members, particularly since history has shown that private and public investors are reluctant to invest in a broker-dealer during adverse market conditions which may themselves give rise to further capital needs.

The securities industry is presently struggling for additional capital.²⁵ Expanded volume and probable limitations on the use of customers' funds by broker-dealer firms—a practice commonly referred to as *free credit balances*²⁶—will increase the necessity for added capital. In response to this need, institutional membership has benefitted the securities industry, the P-B-W and other regional exchanges, and other member firms and their customers by adding capital to the industry and by keeping large orders within the exchange system. Under these circumstances, the regulatory authorities cannot ignore such a beneficial source of capital and the strength which institutional membership imparts to the public securities market.

II. ANALYSIS OF THE ARGUMENTS AGAINST INSTITUTIONAL MEMBERSHIP

A. *Unfair Cost-Savings Advantages*

1. *Fixed Minimum Commissions Rate Structure and Recapture—The SEC Policy Report*

Notwithstanding the favorable P-B-W experience, institutional membership has been unfavorably received in certain quarters, most notably the SEC: The Commission has cited the present structure of a fixed minimum commission rate within the securities industry as one reason for its opposition to institutional membership.²⁷ This rate structure imposes a fixed minimum brokerage commission on all orders

²⁵ *Id.* at 17-18.

²⁶ Free credit balances have been described as customer funds [which are] held by a broker and [which] are not . . . subject to any rules which restrict their use. Free customer credit balances form a substantial part of the working capital of many broker-dealers and are often used for the general operating needs of the broker-dealer's business, for financing its trading and investment accounts and for loans to other customers to finance margin [*i.e.*, credit] transactions.

Miller & Carlson, *supra* note 5, at 75 n.187.

²⁷ SEC Policy Statement, *supra* note 1, at 28-34.

having a value of \$500,000 or less.²⁸ Negotiated rates are permitted on that portion of each order which exceeds \$500,000.²⁹ In fact, commissions charged on the latter portion are substantially lower than the fixed rate.³⁰

To avoid or mitigate the cost of fixed brokerage commissions, many institutional investors affiliated themselves with brokers and effected substantial savings by means of recapture. However, the SEC stated that "[s]o long as such a [rate] structure exists, large investors should not, by virtue of their economic power and size, be entitled to obtain rebates of commissions not available to other investors."³¹ In addition, the SEC decried recapture arrangements between institutional investors and their affiliated brokers as a "use of exchange membership for private purposes rather than for the purpose of serving the public in an agency capacity or otherwise performing a useful market function."³²

The thrust of the SEC's fixed commission argument against institutional membership was that affiliated arrangements provide institutional investors with an unfair cost-saving advantage over smaller nonaffiliated investors. However, in its recent policy report the Commission removed some of the basis for this argument by announcing that no later than April, 1972, the negotiated rate level would be reduced to \$300,000.³³ This reduction means that the fixed minimum commissions rate will apply only to orders having a value of \$300,000 or less. SEC Chairman William J. Casey also has indicated that the Commission may eventually lower the negotiated rate level to \$100,000.³⁴ In fact, Senator Harrison A. Williams, Chairman of the Senate Banking Subcommittee, has introduced a bill that would lower the negotiated rate level to \$100,000 beginning after December 31, 1973.³⁵ Since negotiated commissions have proven to be substantially lower than the fixed minimum rates, nonaffiliated investors now will be able to effect significant savings. In addition, the reduced negotiated rate level will nearly eliminate any imbalance in cost savings which the SEC has alleged is unfair since "[t]here is general agreement that on transactions below \$100,000 the potential savings available through exchange membership is much less significant."³⁶

²⁸ Id. at 28.

²⁹ Id.

³⁰ Id. at 32. See also *Wall Street Journal*, March 9, 1972, at 3, col. 1.

³¹ SEC Policy Statement, *supra* note 1, at 46-47.

³² Id. at 47.

³³ Id. at 33.

³⁴ *Wall Street Journal*, March 9, 1972, at 3, col. 1.

³⁵ S. 3347, 92d Cong., 2d Sess. (1972). See *Wall Street Journal*, March 13, 1972, at 8, col. 4.

³⁶ Id.

Notwithstanding the impending action on the fixed minimum commission rate schedules, the Commission's opposition to institutional membership as a "use of exchange membership for private purposes"³⁷ is but a vague and groundless argument which is inconsistent with the institutional membership situation experienced by the P-B-W. Institutional membership on this exchange has permitted financial institutions to internalize brokerage functions within their corporate structure, thereby obviating the need to purchase brokerage services. As a result, millions of dollars in commissions have been saved by the institutions, savings which have been passed on to the millions of individual investors represented by those corporate investment pools. In addition, the SEC's public-private distinction is inconsistent in light of the fact that the Commission has not attempted to restrict certain "private" activities of noninstitutional members of the various stock exchanges. The SEC's proposal that exchange members should perform a "predominant portion" of their brokerage for unaffiliated customers does not seem to preclude private activity, currently allowed by the NYSE, whereby nonaffiliated brokers concentrate a substantial portion of their activities on principal trading for their own account.³⁸

Further, pursuant to its position that "public" brokerage activity can occur only where "a predominant portion of [an exchange member's] brokerage commission business [is conducted] for non-affiliated persons,"³⁹ the SEC has stated that "[n]on-affiliated persons include individual discretionary and non-discretionary accounts and the accounts of non-affiliated institutions, but do not include institutional parents or investment companies or other institutional funds which are managed under contracts or arrangements which give the broker-

³⁷ SEC Policy Statement, *supra* note 1, at 47.

³⁸ In a recent letter to the SEC, Elkins Wetherill, President of the P-B-W and co-author of this article, cited the following "private" activity which would not be prohibited by the Commission's proposal:

[T]he Commission would permit Exchange membership to continue for firms: (a) which are substantially engaged in floor trading or other principal trading for their own accounts, or the accounts of their proprietors, in a non-market making capacity, and/or (b) which limit their customers services to a very narrow segment of the investing public, such as giant managed accounts, and/or (c) derive most of their profits, commit most of their capital and allocate most of their personnel to activities other than serving as a broker or dealer in publicly traded securities—for example, venture capital financing, mortgage banking, sale of commodities, real estate or insurance, etc. Viewed from this light, we think that our institutional members are much more appropriate for Exchange membership than are many of the existing "conventional" member firms.

Letter from Elkins Wetherill to William J. Casey, March 2, 1972, in 142 BNA Sec. L. Rep., at E-1 (March 3, 1972).

³⁹ SEC Policy Statement, *supra* note 1, at 47.

age firm investment discretion."⁴⁰ Implicit in this definition is that the sale of mutual fund shares or the shares of other institutional investors by a broker does not constitute public activity if, but only if, the issuer of the shares is managed by the broker—or an affiliate of the latter. This is an extremely arbitrary distinction for which the SEC has, as yet, offered no analytical justification, nor even an attempted explanation.

Significantly, neither the SEC nor anyone else has ever represented that institutional membership is not in the public interest. In fact, financial institutions represent a substantial portion of the investing public for whom affiliated exchange members faithfully perform brokerage services. Thus the recapture of commissions by institutional members is more aptly characterized as a benefit for a significant faction of the investing public, rather than the execution of a "private purpose." In addition, a recent decision by the United States Court of Appeals for the First Circuit has held that institutional money managers have a duty to effect brokerage commission savings whenever possible; the court further indicated that there may be a duty to recapture such commissions.

2. *Moses v. Burgin*

In *Moses v. Burgin*,⁴¹ the investment adviser of a mutual fund had withheld information for an extended period of time from the unaffiliated, or "watch-dog,"⁴² members of the Fund's board of directors. This information would have alerted the directors to the possibility, and in fact the practicability, of using recapture in order to reduce advisory fees.⁴³ Because of defendants' inaction, recapture was not

⁴⁰ Id. at 54.

⁴¹ 445 F.2d 369 (1st Cir. 1971).

⁴² The court described the function and purpose of "watch-dog" directors of investment advisers as follows:

Unlike an ordinary trust, or a business, management's normal activities are frequently touched with [a] self-interest [which benefits] management at least as much as . . . shareholders . . . Congress . . . responded to this problem by enacting a mandatory provision for unaffiliated, that is, independent, watch-dog directors. 15 U.S.C. § 80a-10(a) [§ 10(a) of the Investment Company Act] . . . Management [is] under a duty of full disclosure of information to these unaffiliated directors in every area where there [is] even a possible conflict of interest . . .

⁴³ 445 F.2d at 376.

⁴³ Information regarding the desirability of using recapture was presented to the Management defendants on two occasions. In June, 1965, in the course of SEC inquiries regarding the trading activities of the Fund on the Detroit Stock Exchange, an SEC representative suggested that the defendants could effect indirect recapture for the benefit of the Fund by obtaining "give-ups"—wherein at the direction and for the benefit of an investment adviser there is a relinquishment of some of the brokerage commissions on

effected by the Fund. As a result, a stockholder derivative action alleging a breach of fiduciary duty was instituted against the investment adviser and the Fund. More specifically, the plaintiff alleged that "Fund's give-up practices . . . resulted in the loss of the value of brokerage commissions which could have been recaptured . . . either by creation of a broker affiliate that could participate in Fund portfolio transactions, or by channeling present give-ups to an affiliate, with the result that in either case the sums involved would be credited to the fund."⁴⁴ The defendant argued that there was no duty to recapture, and that even if recapture could have been effected, as a practical matter, "the directors still had a right to choose between recapture of the give-ups for Fund's direct benefit, and awarding them to brokers for its indirect benefit."⁴⁵ In finding for the plaintiff, the court held that "if [recapture] was freely available to Fund, the directors had no such choice."⁴⁶ In making this determination, the court reasoned that although sound business reasons⁴⁷ preclude the imposition upon a fund of a duty to acquire a broker affiliate, "[i]nsofar as a fund has a broker affiliate" there is a duty to recapture whenever practicable.⁴⁸

The defendant also argued that recapture was illegal since it violated the "anti-rebate" rules of the various stock exchanges.⁴⁹ The lower court had agreed, adding that recapture has "the evil consequence of giving back to the customer a dollar credit traceable directly or indirectly to the commission he paid."⁵⁰ However, in response to this contention the Court of Appeals stated:

The very fact that one type of rebate was uniformly tolerated by the exchanges despite their anti-rebate rules in itself shows that logic alone cannot supply the answer. The con-

a particular transaction by the executing broker to another broker not connected with the transaction—which could be offset against the advisory fee:

The suggestion . . . should clearly have imparted to Management the idea that its benefit could now conflict with Funds' interest—and should, in turn, have made these defendants sensitive to the need for passing the suggestion along to the unaffiliated directors.

Id. at 377.

Again in 1966, SEC representatives conducting inquiries into commission rate structures suggested that recapture should be effected for the benefit of the Fund. Although the conflict was clearly presented to Management's attention, the watch-dog directors were still not informed. Id. at 378.

⁴⁴ Id. at 372.

⁴⁵ Id. at 374.

⁴⁶ Id.

⁴⁷ Id. at 375.

⁴⁸ Id.

⁴⁹ Id. at 381.

⁵⁰ *Moses v. Burgin*, 316 F. Supp. 31, 57 (D. Mass. 1970). This statement by the district court has been criticized as overstating the limitation ascribed to the anti-rebate rules since dollar-for-dollar offsetting is allowed. 69 BNA Sec. L. Rep., at A-2 (Sept. 23, 1970).

trolling answer must be found in how the exchanges, who were the rule-makers, themselves translated their rules. We have seen that the Pacific and PBW exchanges, when confronted with proposals for recapture, chose to permit it.⁵¹

The First Circuit Court of Appeals was not alone in its recognition of a duty to recapture whenever practicable in broker-affiliate situations. Shortly after the *Moses v. Burgin* suit was instituted in December, 1971, the SEC issued a release proposing a new rule, 10b-10, which provided:

(1) It shall be unlawful for any registered investment company or affiliated person of such registered investment company to directly or indirectly, to [*sic*] order or request any broker or dealer:

(a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person *unless* pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to the remittance. . . .⁵²

Although the acknowledged purpose of the proposed rule was to prohibit give-up practices, the release stated that "[t]he reasoning on which the proposed rule is based is that if . . . 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.*"⁵³ The Commission later withdrew the 10b-10 proposal, but only because the New York Stock Exchange and other exchanges initiated their own rules prohibiting give-ups.⁵⁴

Both the *Moses* decision and the SEC release regarding rule 10b-10 confirmed the legality and desirability of recapture. The direct beneficiaries of recapture are the many individuals who have invested their savings in institutional investment programs. For example, in a mutual fund situation

[i]f Fund receives the asset value of new shares, but at the same time rewards the selling broker with give-ups that it has a right to recapture for itself, then the net income Fund receives from the process of selling a share is less than the

⁵¹ 445 F.2d at 382.

⁵² 33 Fed. Reg. 2393 (1968).

⁵³ Securities Exchange Act Release No. 8239 (Jan. 26, 1968) [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,523, at 83,085 (emphasis added).

⁵⁴ Miller & Carlson, *supra* note 5, at 35 n.1.

asset value. The existing shareholders have contributed—by paying more than otherwise necessary on Fund's portfolio transactions—to the cost of the sale, which was supposed to have been borne by the new member alone.⁵⁵

In addition, since institutional investors represent a significant portion of the investing public, and since the benefits of recapture accrue to these individuals, it must be concluded that recapture, made possible by institutional membership, is in the public interest.

3. *Other Motives for Affiliation and Congressional Criticism of the SEC Policy Report*

It should be noted that "reducing the cost of brokerage commissions to the accounts managed by the institutional investor"⁵⁶ has not been the only reason for affiliation between financial institutions and broker-dealers. Some affiliations "were motivated as investments for the parent rather than as a means of combining in one enterprise the brokerage and management of accounts";⁵⁷ other affiliations were the result of a desire by financial institutions "to be affiliated with an organized distribution system."⁵⁸ In its recent policy statement, the SEC found little objection with these motivations since the resulting membership usually included business dealings with those investors who have been vaguely characterized by the SEC as the "general public."⁵⁹ The Commission apparently condones such affiliations since they provide "a useful source of permanent capital for the securities industry."⁶⁰ Thus it would seem that the SEC's primary objection to institutional membership is really a result of the Commission's staunch opposition to recapture within a fixed minimum commissions rate structure. However, as has been discussed, the impending reduction in the negotiated rate level may obviate this objection.

In this respect the SEC's recent policy statement drew criticism from Senator Williams, for "moving so 'slowly and cautiously' to eliminate fixed rates and so 'promptly' to eliminate exchange memberships that some institutions have acquired for the purpose of reducing 'high' fixed-commission costs levied on their stock transactions."⁶¹ Representative John E. Moss, Chairman of the House Banking Subcommittee, who also criticized the SEC for attempting to resolve the

⁵⁵ 445 F.2d at 374.

⁵⁶ SEC Institutional Investor Study, *supra* note 22, at 2296.

⁵⁷ *Id.* at 2299.

⁵⁸ *Id.* at 2300.

⁵⁹ SEC Policy Statement, *Future Structure of the Securities Markets*, at 49 (Feb., 1972) [hereinafter cited as SEC Policy Statement].

⁶⁰ *Id.*

⁶¹ *Wall Street Journal*, Feb. 3, 1972, at 3, col. 2.

institutional membership issue "without waiting for congressional guidance,"⁶² further stated that "the implementation of any far-reaching proposals, pending the final determination by Congress, [would not] be in the public interest."⁶³ To check the SEC's undue haste in this matter, Senator Williams has introduced a proposal which would remove the Commission's power to restrict institutional membership until one year after the \$100,000 negotiated rate level is in force, at which time "we should be in a far better position to determine whether there is an 'institutional membership problem' or whether it is simply a symptom of the 'fixed commission rate problem.'"⁶⁴

B. *Fragmentation of the Securities Market*

Another argument advanced against institutional membership is that the trend of institutional trading will "fragment" the securities market.⁶⁵ This trend has been characterized by an unprecedented growth in the volume of securities transactions⁶⁶ and by a corresponding pressure, generated by institutions, to lower commissions.⁶⁷ It has been suggested that this pressure plus "the inability of the specialist system to cope with the demands of an institutionalized marketplace"⁶⁸ will fragment the market by shifting trade away from the New York Stock Exchange to the regional stock markets, particularly the P-B-W.⁶⁹ In this way, the New York Stock Exchange has argued, "the realistic pricing of securities, reflecting the full forces of supply and demand, will be impaired."⁷⁰

However, this argument is fallacious since it confuses the growing institutionalization of stock market trading with the growing institutional role in brokerage activity. The dramatic trend toward institutionalized markets which marked the decade of the 1960's⁷¹ has not resulted from the relatively new, and as yet insignificant, phenomenon of institutional membership on exchanges. While it is true that the more trading an institutional investor funnels through its regional

⁶² Id.

⁶³ Id.

⁶⁴ S. 3169, 92d Cong., 2d Sess. (1972). See Wall Street Journal, March 13, 1972, at 8, col. 4.

⁶⁵ See SEC Policy Statement, *supra* note 59, at 6; New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2, col. 1; and Carey & Werner, *supra* note 23, at 17.

⁶⁶ SEC Institutional Investor Study, *supra* note 22, at 2311. For example, on the NYSE securities transactions by institutional investors increased by 548% during the period 1960-69. Id.

⁶⁷ Carey & Werner, *supra* note 23, at 17.

⁶⁸ Id.

⁶⁹ Id. See also New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 1, col. 8, and at 2, col. 1.

⁷⁰ New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2 col. 1.

⁷¹ See note 66 *supra*.

exchange broker-affiliate the less commission income NYSE members receive, this factor is a result of the NYSE's outmoded prohibition against broker-affiliates,⁷² and not a fault of institutional membership. In addition, the lowering of the negotiated rate level to \$300,000 will result in reduced commission income for brokers on all exchanges, and the proposed \$100,000 level, if enacted, will remove any remaining illusory vestiges which might have been used as a basis for the "fragmentation" argument.

The SEC's recent endorsement of a single, totally-integrated market also strikes at the heart of this argument. Because of technological developments in computerized communication, the central market system will provide all marketplaces with readily available information on completed trades, as well as quotations in all marketplaces. In this way, "the realistic pricing of securities, reflecting the full forces of supply and demand,"⁷³ will be assured, notwithstanding any shifts in trade volume from one marketplace to another. In addition, since the central market system will require the "[e]stablishment of terms and conditions upon which any qualified broker-dealer [including institutional affiliates] can obtain access to all exchanges,"⁷⁴ there will be little likelihood that trading will be diverted to "inappropriate" marketplaces so as to distort "the realistic pricing of securities."

C. *The Dealer-Oriented Market*

It has also been argued that institutional membership ultimately may cause the brokerage business to become dominated by financial institutions intent on building captive sales forces.⁷⁵ It is contended that this build-up could lead to a dealer-oriented market. It is further argued that such a market would eliminate the broker-customer agency relationship by driving small, nonaffiliated brokerage firms out of business, and by eliminating the individual investor's ability to trade against institutions.⁷⁶ However, if the increasingly institutionalized markets are leaning more toward the dealer function of selling shares, it is because this orientation is better suited to satisfy the legitimate needs of institutional investors, through whom millions of Americans invest. For example, the continual selling of shares is of

⁷² This prohibition is embodied in NYSE Rule 318, CCH NYSE Guide ¶ 2318 (1970).

⁷³ New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2, col. 1.

⁷⁴ SEC Policy Statement, supra note 59, at 10.

⁷⁵ See New York Times, Feb. 20, 1972, § 3 (Business and Finance), at 2, col. 1; and, Miller & Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U. L. Rev. 35, 75 (1971).

⁷⁶ New York Times, Feb. 20, 1972 § 3 (Business and Finance), at 2, col. 1-2.

particular importance to a mutual fund, which must always be prepared to redeem its shares:

A continual flow of new money may be beneficial in giving the adviser more flexibility in managing the portfolio, in achieving long-term investment goals and in avoiding sales of portfolio securities at inopportune times to meet redemptions. . . . Additionally, continual sales might reduce the per share portion of the management fee funds which scale down fees as assets under management increase.⁷⁷

Thus it would seem that the extent to which the securities market has been, and will become, dealer-oriented will be determined by the level of institutionalization of the market, not institutional membership. In fact, contrary to the dangers attributed to institutional membership, the P-B-W has been inundated by no adverse impact on nonblock trade volume (orders of less than 2,000 shares)⁷⁸ as a result of its unrestricted membership policy.

It is interesting to note that many firms own seats on the NYSE in order to trade for their own account,⁷⁹ and some deal more for such accounts rather than acting as broker-agents for customers. Yet, no one has suggested that these firms should lose their NYSE membership because of their dealer orientation. Nor has it been expressed that these firms should be required to devote more of their resources to servicing the individual investor.

D. *The Subsidization of Nonaffiliated Members*

Implicit in the preceding argument by the NYSE that institutional membership will result in a substantial decline in the number of broker-dealers available to serve individual investors is the suggestion that broker affiliations should be prohibited in order that the profits derived from institutional brokerage commissions might accrue to nonaffiliated brokers, to subsidize the brokerage services available to such investors.

⁷⁷ Miller & Carlson, *supra* note 75, at 65. In fact, in February, 1972, mutual fund redemptions exceeded sales by \$88,000,000, and the industry experienced net redemptions during 5 of the 12 months preceding this date. The New York Times, March 21, 1972, at 57, col. 7.

⁷⁸ The SEC has suggested that block trade could be defined as "a securities transaction that, because of its size or other characteristics, requires special handling." SEC, Institutional Investor Study Report of the Securities and Exchange Commission, pt. IV, at 1537 (1971) [hereinafter cited as SEC Institutional Investor Study]. However, the Commission recognized that this definition is inadequate, and possibly for this reason the various exchanges have defined block trades in terms of order sizes. For example, the NYSE generally defines block trade as orders of 10,000 or more shares. *Id.* at 1537. Most regional exchanges, including the P-B-W, define block trades as orders of 2,000 or more. *Id.* at 1819.

⁷⁹ Carey & Werner, Outlook for Securities Markets, Harv. Bus. Rev. at 23 (July-Aug. 1971).

In effect, this suggestion of a subsidy would necessitate subjecting brokers handling institutional accounts to public-utilities type regulations, which would insure that the brokers did in fact subsidize and service the small investors as well as the financial institutions.

However, available statistics support neither the subsidy approach nor the argument upon which the suggestion is based. The NYSE presently prohibits institutional membership⁸⁰ and, therefore, approaches the operating conditions favored by that exchange. Of the more than 250 member firms on the NYSE, only approximately one and one-half per cent of these members derive twenty-five per cent or more of their gross income from institutional commissions.⁸¹ Approximately thirty-six per cent of the NYSE members derive less than five per cent of their gross income from institutional commissions,⁸² and over eighty per cent of the member firms derive no more than fifteen per cent of their commission income from institutions.⁸³ Simply translated, these statistics indicate that exchange membership for institutional dealer affiliates on the NYSE would affect, at most, only a small percentage of nonaffiliated members.

In addition, even though affiliated firms would be primarily engaged in institutional brokerage business, not retail activities for individual public investors, such a situation would be substantially identical to the existing NYSE business pattern. This result would occur notwithstanding the imposition of a subsidy situation. As discussed above, subsidization would require the promulgation of public-utility type regulations. However, not even the NYSE has suggested imposing such rules on brokerage firms. Thus the subsidy approach would fail in its objective since the recipients of the subsidy—nonaffiliated brokers for institutional investors—need not, and by and large presently do not, render the services to individual investors which are intended to be subsidized.

E. *Conflicts of Interest*

Finally, the NYSE has argued that institutional membership poses unique conflict of interest problems.⁸⁴ It is alleged that affiliated members may effect unnecessary brokerage activity through unwarranted portfolio turnover—churning⁸⁵—in order to generate commissions, and that broker affiliates may avoid marketplaces from which the best execution is available. However, since many institutional

⁸⁰ See note 72 *supra*.

⁸¹ SEC Institutional Investor Study, *supra* note 78, at 2236.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ Carey & Werner, *supra* note 79, at 23.

⁸⁵ *Id.*

members are wholly-owned subsidiaries of their parent institutions whose profits accrue directly to the parent, no unique conflict of interest is presented. In fact, the relationship between an affiliated member firm and its parent is more free from potential conflict of interest problems than that of the conventional nonaffiliated broker and its customer.

It should be noted that potential conflicts of interest do arise in "fund complex" arrangements.⁸⁶ In this situation, a group of financial institutions are externally managed "by separately owned and operated organizations known as investment advisers or managers."⁸⁷ Here, the broker-dealer is a subsidiary of the external money manager and performs brokerage services for an investment pool not beneficially owned by the parent-manager. Thus the external management structure is conducive to conflicts of interest, since "the manager does benefit from reciprocity in increased fund share sales commissions and management fees and does benefit where its affiliate retains commissions on fund portfolio brokerage."⁸⁸

However, since broker-dealers affiliated with institutions do perform brokerage services for investments beneficially owned by the institutional parent, this conflicts situation is not present in the institutional membership situation. In fact, with the exception of institutional membership arrangements, this particular conflict is common to the securities industry whenever the functions of a money manager and broker are combined. Many NYSE members are permitted to combine these functions, while institutional applicants performing identical duties are denied NYSE membership.⁸⁹ Gustave Levy, former Chairman of the NYSE, has conceded that "[o]ur Achilles heel has always been that we have been in the money-managing business, but the managers could not get into ours."⁹⁰ In fact, the SEC has indicated that:

[I]n enacting the Investment Company Act Congress apparently did not find it necessary that the brokerage and investment company functions be completely separated. There are potential conflicts of interest in these relationships, as well as in the broker-underwriter relationship, the money manager-underwriter relationship and the dealer-money manager relationship. If all of these functions were to be separated, the capital-raising capability of the industry and its ability to serve the public could be significantly weakened. We there-

⁸⁶ Miller & Carlson, *supra* note 75, at 42.

⁸⁷ *Id.*

⁸⁸ *Id.* at 49-50.

⁸⁹ Carey & Werner, *supra* note 79, at 23.

⁹⁰ *Id.*

fore believe that the conflict of interest problem which is inherent in the combination of money management and brokerage is a matter to be resolved by Congress.⁹¹

CONCLUSION

The P-B-W's experience with institutional membership indicates that affiliated membership is beneficial to the exchange, to its non-affiliated members and their customers, and to the investing public. The volume of trade generated and the capital committed by the institutional members have contributed substantially to the growth of the P-B-W, strengthening the position of the exchange as an independent competing marketplace. As a result, the P-B-W has been able to serve directly the needs of sound, but small, nonaffiliated firms that are unable to afford NYSE membership. In this way, the exchange has been able to serve, indirectly, the small individual customers of those firms.

Institutional membership has been attacked, primarily by the SEC, as being contrary to the best interests of the securities industry. The underlying reason for this opposition is the cost-savings advantage which accrues to institutional investors. However, the impending reduction of the negotiated rate level and the recent decision in *Moses v. Burgin* have substantially vitiated the recapture argument. Other arguments—concerning fragmentation of the industry, the evolution of a dealer-oriented market and the subsidization of non-affiliated members—must also be discounted, since they represent problems inherent in the institutionalization of the securities market, which is not to be confused with institutional membership.

Further, it is recognized that institutional membership does not present a potential conflict of interest problem in the external management situation. This potential conflict is a product of the investment manager-broker relationship. However, with the exception of institutional membership, this relationship and the attendant conflicts problem are familiar to the securities industry. Institutional membership has significantly benefitted the securities industry by providing capital commitments and by keeping large orders within the exchange system. The continued growth of such membership, untrammelled by restrictions based on artificial justifications, will undoubtedly strengthen the public securities market.

⁹¹ SEC Policy Statement, *supra* note 59, at 52-53.