Conflict of Interest in the Allocation of Mutual Fund Brokerage Business

As mutual funds[1] have mushroomed in size during the past decade,[2] the Securities and Exchange Commission has become increasingly concerned that the funds be managed in the best interests of their shareholders. In particular, the SEC has criticized fund managers for using fund assets, in the form of brokerage commissions, to stimulate further fund growth through the sale of new shares to the public. The Commission's criticism stems from the fact that the structure of the typical mutual fund allows the manager to profit at the shareholders' expense. The conflict of interest is stark—managers always benefit from the sale of new fund shares, because their compensation is tied to the level of fund assets; shareholders ordinarily do not benefit from such sales, yet pay the cost of promoting them through excessive brokerage commissions or poor executions of brokerage orders. For example, to augment the dealer discount[3] received by brokers who sell his fund's shares, a manager will often reward broker-salesmen with brokerage business; the amount of this business will vary with the success of the brokers' efforts to sell fund shares[4] and not necessarily with their expertise in executing brokerage orders.

1. "Mutual fund" is the common term for an "open-end management company." Section 4 of the Investment Company Act, 15 U.S.C. § 80a-4 (1964), divides investment companies into three classes: "face-amount certificate companies," which sell discounted debt securities, yielding predetermined returns, on an installment basis; "unit investment trusts," which issue only redeemable securities representing interests in other, specified securities; and "management companies," or all other investment companies. A management company is open-ended if it issues redeemable securities, which almost all mutual funds do on a continuing basis.

General information about mutual funds has been taken largely from SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. (1966) [hereinafter cited as POLICY REPORT]. This report sets forth the SEC's recommendations regarding the funds, and also summarizes and updates the findings contained in the REPORT OF THE SPECIAL STUDY OF THE SECURITIES MARKETS OF THE SEC, pt. 4, H.R. DOC. No. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as SPECIAL STUDY] and WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. No. 2274, 87th Cong., 2d Sess. (1962).

2. Since the end of 1959, total fund assets have grown from $15.8 billion to about $41.1 billion. Before the 1969-70 market decline, total assets reached $58.9 billion. INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK 75, 78 (1970) [hereinafter cited as ICI FACT BOOK]; FUNDSCOPE, January, 1971, at 25.

3. The dealer discount is that part of the total sales commission paid by the purchaser of fund shares which is retained by the selling broker—usually about 7.1 per cent of the value of the shares sold. Since the principal underwriter of the shares generally retains an additional 2.2 per cent, the total sales commission is usually about 9.3 per cent. POLICY REPORT 207.

4. Since a manager must grant the same dealer discount to all brokers who sell his

The SEC has in the past attempted to mitigate this conflict of interest by regulating the commission structure of the New York Stock Exchange (NYSE), where from 75 to 80 per cent of fund brokerage business is transacted.[5] Yet the managers' more objectionable practices have survived these reforms and will persist even if the SEC's latest proposal for reform—the introduction of negotiated brokerage commission rates[6]—is adopted.

Congress recently focused on a related problem in its first major regulation of mutual funds since 1940—the Investment Company Amendments Act of 1970. The new act seeks to insure that the managers' compensation will be reasonable by allowing fund shareholders to challenge the level of compensation in federal court and by strengthening the hand of independent fund directors, who must approve all management contracts. If it were effective, the act might diminish managers' incentives to promote fund sales with brokerage commissions. This Note will argue, however, that the act has not appreciably increased directors' bargaining power vis-a-vis fund managers; and that to do so, Congress would have to make changes in the structure of funds which would probably not be politically acceptable. The only effective solution is therefore to deal with the problem directly—to prohibit brokers from executing orders for funds whose shares they sell.

I. Mutual Fund Structure

The structure of the externally managed mutual fund is unique among American corporations. Although the fund itself has a board of directors and one or more executive officers, the board contracts out the management of the fund to an external organization called an "investment adviser," usually a partnership or corporation. The adviser performs the duties which would fall to the officers of an ordinary corporation—primarily the selection of the fund's portfolio and the allocation of its brokerage business. In addition, the adviser generally provides the fund with office space, clerical personnel, and such non-

fund's shares, 15 U.S.C. § 80a-22(d) (1964), he can only differentiate between brokers by varying the amount of brokerage commissions they receive.

5. SEC Rate Structure Investigation of the National Securities Exchanges. File No. 4-144, at 1980, 2066, 2243, 2486-87 (1968-69) [hereinafter cited as Rate Hearings]. These recent and exhaustive hearings are an excellent source of information regarding the allocation of fund brokerage business, brokerage commission rates and related matters.

6. The Commission has proposed the negotiation of commissions "for that portion of [a brokerage] order in excess of $100,000." SEC Exchange Act Release No. 9007 (October 22, 1970).

advisory services as those involved in stock transfers and dividend disbursements. In most cases, a fund also contracts out to the adviser or its subsidiary the exclusive right to underwrite fund shares. These unusual arrangements—summarized by the phrase "external management"—are holdovers from the earliest mutual funds, many of which were created by investment counselors to pool the resources of their small clients. The early advisers treated their creations much like wealthy individual clients and, in any case, "not as businesses capable of existing independently of their sponsors."[7] While today's giant mutual funds are independent businesses in every sense, they retain the early structure.

An adviser's legal obligations to its fund are governed by an "advisory contract" which, according to §§ 15 (a) and (c) of the Investment Company Act,[8] must be written and unassignable, approved originally by a majority of fund shareholders, and renewed annually by vote either of the shareholders or of those directors, numbering at least 40% of the board,[9] "unaffiliated" with the adviser. However, while "unaffiliated" directors may not be officers or employees of the fund, its adviser, or its adviser's affiliates, they may each own up to 4.9 per cent of the adviser's voting stock and may be relatives or friends of "affiliated" colleagues.[10]

The advisory contract must also "precisely describe all compensation to be paid"[11] the adviser for services. In almost all cases, this compensation, called an advisory fee, is a fixed percentage of the fund's average net assets for the year—usually about 0.5 per cent, at least for the first several hundred million dollars in fund assets.[12] Thus, increases in fund assets through successful investments mean increased advisory fees. However, since the capitalization of outstanding fund shares is not deducted from assets when net assets are calculated, increases in advisory fees also result from the mere sale of new fund shares. Indeed, such sales are the more important source of fee increases, since most funds, for tax reasons,[13] distribute virtually all of their investment income and

7. POLICY REPORT 50.
8. 15 U.S.C. §§ 80a-15(a) and (c) (1964).
9. In addition, if any of the fund's directors, officers, or employees is affiliated with the fund's principal underwriter, a majority of directors must be unaffiliated with that underwriter or its own affiliates; the same restriction applies with respect to the fund's "regular brokers" and to all investment bankers. 15 U.S.C. §§ 80a-10(a) and (b) (1964).
10. *See* 15 U.S.C. § 80a-2(a)(3) (1964). Stricter requirements set by the recent amendments to the Act, *see* p. 388 *infra*, will go into effect in December, 1971. *See* Pub. L. No. 91-547, §§ 5, 30(1) (Dec. 14, 1970).
11. 15 U.S.C. § 80a-15(a)(1) (1964).
12. POLICY REPORT 97-100.
13. Under specified conditions, INT. REV. CODE of 1954, § 852, permits funds to deduct

realized capital gains to shareholders.[14] Advisers therefore have a powerful incentive to stimulate fund sales—an incentive which has greatly influenced their management of fund brokerage business.

II. The Allocation of Mutual Fund Brokerage Business

Brokerage commissions for the purchase or sale of a mutual fund's portfolio stock are paid from fund assets rather than from advisory fees. To conserve fund assets, therefore, an adviser ought ideally to place brokerage orders with brokers who will achieve the best possible executions of the orders—purchase or sale at the best price available, without unnecessary charges. If his only goal were to obtain "best executions," the adviser would select brokers solely on the criterion of brokerage expertise[15] with respect to the orders in question, and would compensate them only for executing the orders. In fact, however, advisers have used their power over brokerage distribution to pursue three major additional goals: they have used commissions on portfolio orders to reward brokers for "positioning" other fund orders, for providing research and related services, and for selling the fund's own shares to the public.[16]

Before examining the devices which advisers have employed to allocate commissions, it is important to consider whether these purposes are legitimate in light of advisers' obligation to manage their funds in the shareholders' interest. Brokers known as "block positioners" perform an important service for mutual funds by acting as principals in

dividend distributions which equal or exceed 90 per cent of taxable income and realized capital gains, respectively.

14. A fund's investment gains may increase advisory fees in two ways—until they are distributed, the gains tend to increase average net assets; and the gains may be reinvested in the fund if the shareholders elect to receive distributions in the form of new shares rather than cash. However, "reinvestment" sales have not exceeded 44 per cent of total sales in any of the past ten years, and have averaged about 30 per cent. *See* ICI FACT BOOK 18, 22, 61-62, 65-66, and POLICY REPORT 203. Although these sources do not report the amounts of capital gains distributions which were reinvested from 1966 to 1968, over 80 per cent of such distributions were reinvested from 1962 to 1965, and almost 90 per cent in 1969. Reinvestment of capital gains for 1966-68 has therefore been estimated at 80 per cent.

15. Brokerage expertise may be defined as the ability to secure the best price available, keep the client's intentions secret, and make sure that no trade unduly affects the market in the security brought or sold. On the NYSE, this often entails more than walking to a trading post and simply selling or buying at the currently bid or offered price. It requires a sense of timing and some familiarity with the past trading pattern of the security involved, as well as a "feel" for the overall trend of the market. Especially with large orders, it may also include a familiarity with other brokers or institutional investors who are likely to have an interest in the security.

16. Information about block positioning has largely been obtained in interviews with partners in several NYSE firms [hereinafter cited as Industry sources].

order to execute difficult orders to sell "blocks" of 10,000 or more shares.[17] Because funds often hold vast quantities of particular securities, advisers frequently wish to sell large blocks. Yet, since buyers can seldom be found for all the stock involved,[18] the making of large block trades often depends upon a positioner's willingness to purchase ("position") the excess stock and carry it at market risk until it can be sold.[19] Although a positioner attempts to resell positioned stock at a profit, losses are frequent and large, and may offset the brokerage commissions paid on a positioned order.[20] In effect, by purchasing stock which a fund could not otherwise sell at the time, a positioner assumes much of the transaction cost of liquidating the fund's holdings—the drops in price which do not reflect fundamental value, but rather an excess of supply.

17. Sellers initiate most large block trades. Industry sources give several reasons for this. If a stock "runs away" from a buyer in a rising market, he has not suffered any actual losses, and has made a profit on any stock already purchased. In addition, he will be reluctant to buy a large quantity of stock if a positioner is selling it short to him. On the other hand, large sellers risk actual losses on market declines; they usually want to liquidate quickly and shift their risk to positioners.

Blocks now account for over 14 per cent of NYSE volume. The number of blocks has increased nearly 600 per cent in the last five years, so that in 1969 over 15,000 blocks traded, averaging over 26,500 shares each. NYSE FACT BOOK 12 (1970). Of course, trading by institutional investors other than funds contributed to this total.

18. Rate Hearings 2617-18; POLICY REPORT 285; Industry sources.

19. Positioners' trades often occur in the following way. A fund asks a positioner to sell 100,000 shares of XYZ common stock; all the stock must be sold at the same time, the price must be close to the previous sale, and the transaction must be completed quickly. While contacting potential buyers by telephone, the positioner also tries to locate any other large sellers of XYZ and consolidate their stock with the fund's. If he fails to do this, a large block may trade and depress the price of XYZ before he can find buyers for the fund's stock; or a large block may sell down after the fund's stock has traded, leaving the positioner and his buyers with immediate losses.

Perhaps the positioner finds four other funds willing to buy a total of 75,000 shares, and negotiates a common price acceptable to the seller. In order to complete the trade, he must position 25,000 shares himself. He does this when the negotiated trade for all 100,000 shares is formally executed on the NYSE floor. However, the specialist in XYZ may be willing to buy 5,000 shares, and there may be orders on the floor to buy XYZ at prices higher than that which the positioner has negotiated. This often happens when blocks trade at discounts from previous sales. If there are such orders they may break up the arranged trade, since they must be filled at the lower, negotiated price before either the positioner or his buyers can purchase any shares.

20. Industry sources; Rate Hearings 763. In the illustration in note 19, *supra*, the positioner would receive commissions on 175,000 shares—on 100,000 from the seller, and on 75,000 from the buyers. He would figure his profit, if any, by deducting his costs and any losses incurred in reselling the 25,000 shares he has positioned.

With respect to this stock, the positioner is at a greater disadvantage than the ordinary seller, largely because of the publicity given the trade by the ticker tape. Other traders usually calculate that a positioner has taken the buyers out of XYZ, and that his own stock is overhanging the market. Hedge funds, in particular, will often sell XYZ short, competing with the positioner and eating up buying interest. Further, "the fact that initial activity generates additional activity in the direction of the initial change in prices is a well-known market phenomenon." WHARTON REPORT, *supra* note 1, at 359. If the original 100,000 shares trade below the previous sale, other funds holding XYZ often become anxious to sell their own stock. Their attempts to do so may, of course, further depress the price of XYZ. However, even if the price of XYZ rises, large potential buyers often know the price at which the positioner bought XYZ and are unwilling to pay him more for it.

If the fund retained the positioned stock and attempted to liquidate it gradually, the fund would incur this transaction cost itself. The interests of an adviser and fund shareholders are therefore not in conflict if the adviser "purchases" a positioner's services with brokerage commissions on subsequent, riskless orders which need not be positioned. Moreover, positioners generally possess sufficient brokerage expertise to execute the orders well.[21]

The second and more questionable goal which advisers pursue by allocating brokerage commissions is the purchase of research services. Whether advisers may legitimately use fund assets for this purpose depends on the proper construction of advisory contracts. Such expense is arguably improper because investment research is a task intimately connected with the selection of a fund's portfolio. When an adviser contracts to manage a fund's assets, it also obligates itself, at least by implication, to base its decisions on reasonably valid information and to gather that information. Thus, to reward brokers for research services is to spend additional fund assets for services which the adviser has contracted to perform and for which it is already compensated by advisory fees.

On the other hand, according to some brokers and advisers,[22] advisory contracts impliedly contemplate the expenditure of brokerage commissions for "corroborative" research, research which supplements the investment advice purchased by advisory fees. They argue that if payment for research services must come from advisory fees rather than from brokerage commissions, advisers will skimp on research rather than risk derivative suits over the fee increases that would be necessary to pay for the research. This argument assumes a great deal, however. Since advisers literally create their funds and exercise considerable influence over the appointment of fund directors, advisory contracts are rarely the products of arm's length bargaining; whether or not they "contemplate" corroborative research is largely determined by advisers' fiat. The argument also assumes that advisers cannot properly manage fund portfolios without corroborative research and that present advisory fees, as well as the amounts spent for corroborative research, are reasonable. The validity of these assumptions is at least questionable. It is not even known whether the research provided by brokers is indeed corroborative in nature.

21. Block positioning is more "complex and difficult" than executing orders on the NYSE floor, Rate Hearings 1993, 2503, and involves many of the same skills; a broker who can do the former can do the latter.
22. Rate Hearings 779, 827-28, 1800, 2116.

Yet, the advisers' argument is not necessarily fallacious. Although basic investment data is available at small cost in various publications, "many fund managers place great stress on impressions of portfolio company managements derived from field visits."[23] The advisory fees paid by smaller funds may not meet the cost of visiting an appreciable number of companies. After assembling the available data about a company it cannot visit, an adviser may use brokerage commissions to obtain first-hand information gathered by a brokerage firm's analyst. Even the advisers of larger funds may occasionally wish to obtain advice from analysts who specialize in particular industries or companies. Moreover, brokers have traditionally provided customers with investment advice without additional charge; the practice may be a desirable form of service competition between brokers. As long as an adviser conducts its own research in good faith and purchases research only occasionally or on a broker's initiative, it probably remains within the spirit of its advisory contract.

The third and, from the fund shareholder's perspective, least justifiable use of brokerage commissions is to stimulate sales of the fund's own shares. Because of the escalator clause in advisory contracts, fund sales, as noted above, benefit advisers by increasing advisory fees. However, because a fund share must by law be issued and redeemed at a price as close as possible to its current net asset value,[24] sales do not in themselves benefit existing shareholders.

Advisers have claimed[25] that fund sales benefit shareholders indirectly by adding capital which insures a fund's ability to redeem outstanding shares and enables advisers to increase their funds' cash positions in declining markets without selling portfolio stock. But it is doubtful whether advisers have used brokerage commissions to promote sales only to the extent required to obtain these benefits.

Over the past ten years, the ratio of fund share sales to redemptions has been nearly two to one, and net sales have totaled more than $20 billion.[26] Annual "reinvestment" sales, which result when shareholders elect to receive share dividends instead of cash, have alone offset more than half, and often two-thirds, of annual redemptions.[27] Additional sales—those which advisers can stimulate with brokerage commissions—have annually produced from two to five times the capital needed to

23. Policy Report 85.
24. 15 U.S.C. § 80a-22(a) (1964).
25. *See, e.g.*, Rate Hearings 2119.
26. *See* ICI Fact Book 65-66.
27. *See* note 14 *supra*.

offset the remaining redemptions.[28] Advisers also exaggerate the danger posed by redemptions; if the funds had sold shares only through reinvestments, advisers could have met redemptions by liquidating no more than 4 per cent of fund assets on the average.[29]

Moreover, especially in declining markets, judicious portfolio liquidations, rather than the sale of new fund shares, may be the better method of obtaining cash—either to meet redemptions or to make new investments.[30] Of course, a fund's growth through sales may produce economies of scale, particularly in the cost per share of custodial services, stock transfers, and dividend disbursements.[31] SEC studies show, however, that the performance of the largest funds, as measured by net asset value per share plus cash dividends, "has been no better than that of all funds in similar investment-objective categories."[32] These funds' "many advantages have been apparently offset by the lack of portfolio mobility and flexibility attributable to their size."[33] Thus, fund shareholders have derived little benefit from sales per se or from resulting increases in fund size. On the other hand, as noted, sales *always* benefit advisers; they receive increased advisory fees and, as their funds grow, they are able to use even greater amounts of brokerage commissions to promote fund sales.

III. Attempts at Reform

In the past, SEC attempts to insure that fund brokerage commissions are spent only for proper purposes have taken the form of changes in NYSE rules regarding the commissions themselves. Because these

28. *Id.*
29. *Id.*
30. According to a recent report, N.Y. Times, December 12, 1970 at 46, col. 3-4 (city ed.), some advisers have been unduly reluctant to liquidate poorer fund investments where this would result in the realization of capital losses. Such losses would offset capital gains which could otherwise be distributed to fund shareholders, *see* pp. 374-75 *supra*, and the advisers fear that shareholders would each redeem a few shares to make up for the lost distributions.
31. Policy Report 252-53. It should be noted that since funds usually pay for these services through advisory fees, advisers alone benefit from such economies of scale unless they reduce their fees accordingly. Moreover, potential fee reductions are not discounted in the price of fund shares, which must be redeemed at their current net asset value.
32. *Id.* at 263.
33. *Id.*

"[Some advisers] maintain that it is difficult, even impossible, to secure meaningful investment results from the management of mammoth size portfolios. For this reason, many of them have on their own initiative decided to cut off sales of new shares above a certain specified limit which in most cases is $100,000,000." *Hearings on H.R. 11995 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., pt. 1, at 233 (1969) (SEC memorandum in answer to committee questions) [hereinafter cited as *Hearings on H.R. 11995*].

attempts at reform have not been tailored to the problems created by advisory contracts, they have not prevented advisers from using commissions to promote fund sales.

A. *The Give-up System*

Before December, 1968, high minimum commission rates, together with split commissions called "give-ups," permitted advisers to obtain positioning, research and sales services without sacrificing best executions. Advisers directed most fund orders to a few "lead brokers,"[34] selected for their superior brokerage expertise,[35] who executed the orders and received full NYSE commissions. The lead brokers then "gave up" part of the commissions—often as much as 60 per cent[36]—to other brokers designated by the advisers. Since all of the positioners served as lead brokers to various funds, and therefore executed many fund orders, they did not receive give-ups; rather, in return for their positioning services, they retained full commissions on the positioned parts of orders, and gave up less on riskless, unpositioned orders than did lead brokers in general.[37]

Largely through give-ups, however, advisers channeled the bulk of fund commissions to other brokers who executed relatively few fund orders, as compensation for their fund-selling and research services.[38] Indeed, advisers attempted to reward each fund-selling broker with a preset amount of commissions, equal to a fixed percentage of the value of the fund shares he sold to the public.[39] According to SEC studies, of the $42 million spent in brokerage commissions by the twenty largest funds between July, 1965, and June, 1966, advisers estimated that they channeled 53 per cent to brokers as added compensation for selling fund shares to the public, and 13 per cent for research and related services.[40] However, advisers could not be faulted for rewarding brokers for either sales or research services as long as the NYSE allowed give-ups. Under the exchange's minimum commission structure, advisers could correctly argue that they received best executions for fund orders; they selected

34. Rate Hearings 1722, 1843, 1982, 2272.
35. *Id.* at 2282, 2482.
36. *Id.* at 1733, 1850-51, 1994.
37. *Id.* at 562, 578, 603, 691-92, 759-61.
38. *Id.* at 1760, 1842, 2271.
39. *Id.* at 1748, 1864, 2096. This figure was as high as five per cent for larger fund-sellers, and ranged from one and one-half to two per cent for smaller fund-sellers. *Hearings on H.R.* 11995 at 215.
40. Policy Report 165-66.

lead brokers on the basis of brokerage expertise, and their funds paid no unnecessary charges.[41]

Yet for several reasons, the prevalence of give-ups caused SEC consternation. Advisers were using part of NYSE commissions, at least on large fund orders, to pay for services which were unrelated to the execution of orders on the exchange. If executing brokers could distribute give-ups and also profitably give excellent service, NYSE rates on large transactions were too high. In many cases, therefore, fund shareholders paid too much for brokerage services and derived little benefit from the additional expenditures. Moreover, give-ups were discriminatory rebates from which only fund advisers could derive substantial benefits; brokers performed no services for other customers which were comparable to the sale of fund shares and could be purchased with give-ups.

B. *The Interim Schedule*

As empowered by § 19(b) of the Exchange Act,[42] the Commission therefore asked[43] the New York Stock Exchange in May, 1969, to prohibit give-ups, and either to replace minimum commissions with negotiated rates or to establish a discount for large orders. In December, 1969, the Exchange complied by abolishing give-ups and promulgating an interim[44] rate schedule which included a volume discount. The SEC

41. An adviser which was also a NYSE member firm could have received give-ups itself and applied them in reduction of its advisory fee, since the NYSE's anti-rebate rule, *CCH, NYSE Guide* § 1701 (1968), then only prohibited the payment of give-ups to non-members. However, because the exchange required that a member's "primary purpose" be "the transaction of business as a broker or dealer in securities," *Id.* § 1407(b)(4), only a few advisers could "recapture" give-ups—those advisers which had originally been brokerage firms and which maintained a general brokerage business, and those which could find brokers willing to affiliate with them. Alternatively a fund's directors could break relations with the fund's adviser and replace it with a NYSE member firm. In Moses v. Burgin, 316 F. Supp. 31 (D. Mass. 1970), the court rejected a fund shareholder's claim that fund directors and advisers were obliged under the Investment Company Act to enter into such "recapture" arrangements; the court relied primarily on the directors' business judgment that such arrangements would create conflicts of interest between a broker-adviser and the fund. 316 F. Supp. at 41-42, 57-58.

42. Section 19(b) of the Exchange Act, 15 U.S.C. § 78s(b) (1964), authorizes the SEC to ask a national securities exchange to make such changes in its rules and practices as are "necessary or appropriate for the protection of investors . . . or to insure fair administration of such exchange . . . in respect of such matters as . . . (9) the fixing of reasonable rates of commissions . . . ." If the exchange fails to enact the requested rule after "appropriate notice and opportunity for hearing," the SEC is empowered to do so.

43. Letter from Manuel F. Cohen, then Chairman of the SEC, to Robert W. Haack, President of the NYSE, May 28, 1968, on file in SEC New York office. The SEC made similar requests of all national securities exchanges.

44. The SEC emphasized that it would consider the present commission schedule "an interim measure," to be replaced by a permanent schedule "as promptly as possible." Letter from Manuel F. Cohen to Robert W. Haack, Aug. 30, 1968, on file in SEC New York office. The exchange proposed a permanent schedule last June, but the Commission has rejected it and asked for the submission of a new proposal by June 30, 1971. SEC Exchange Act Release No. 9007 (Oct. 22, 1970).

expected[45] these changes not only to save shareholders money by making brokerage rates more reasonable, but also to curtail advisers' use of brokerage commissions to stimulate fund sales. Able to distribute fewer commission dollars, advisers would hopefully use them solely to obtain good executions for fund orders.

However, advisers have responded by doing directly what they had formerly done indirectly: they now place the bulk of fund orders with fund-selling brokers, the former recipients of give-ups,[46] since they can no longer allocate brokerage commissions simply by directing the payment of give-up balances at the end of each month. This necessarily entails giving orders to more brokers—in some cases, the size of advisory staffs charged with this function has doubled or tripled.[47] The volume discount has unexpectedly reinforced this trend; to insure that fund-selling brokers receive their preset rewards, advisers must give them more orders than would be necessary in the absence of the discount. The funds' former lead brokers report an enormous loss of business, particularly in smaller orders—to buy or sell several thousand shares or fewer—which can be executed, however badly,[48] by almost any broker.[49]

Fund shareholders have, of course, benefited from the volume discount in undeterminable amounts. But they have been injured in other, perhaps offsetting ways. Brokers report instances where advisers have turned down NYSE bids for stock, in order to accept substantially lower bids from fund-selling brokers on regional stock exchanges.[50] Although such instances are probably rare, they suggest that brokerage expertise is no longer the primary criterion by which advisers allocate orders. In response, advisers have argued[51] that most brokers can handle all but a few difficult fund orders equally well. Yet there is no assurance that proper management of a fund portfolio will dictate the execution of enough easier orders to compensate brokers for their fund-selling or research efforts, and advisers' past practices belie their contention. The differences in brokerage expertise which led advisers to channel most fund business to lead brokers did not suddenly vanish along with give-ups. Neither did the use of a larger number of brokers become

45. POLICY REPORT 187-88.
46. Industry sources; N.Y. Times, Oct. 23, 1970 at 69, col. 8 (city ed.); *Hearings on H.R. 11995* at 234.
47. Industry sources.
48. *See* note 15 *supra*.
49. *See Hearings on H.R. 19955* at 234.
50. Industry sources.
51. *See* Rate Hearings 1993, 2282. However, one broker told the SEC, "There is a great deal of difference between [two] brokers executing 100 shares of Xerox." *Id.* at 155.

more sensible; on the contrary, advisers have testified[52] that the concentration of orders with a few expert brokers is the most economical way to manage a fund portfolio. The implication is that advisers' present practices in fact injure fund shareholders[53] by diminishing the benefits which shareholders would otherwise receive from the volume discount.

At the same time, advisers have helped to create a cost squeeze on positioners which may have impaired the depth and liquidity of NYSE markets. This pressure did not exist as long as positioners served the funds as lead brokers. But the volume discount and the abolition of give-ups, which led advisers to reallocate business to fund-selling and research brokers, have cut deeply into positioners' cushions. Positioners receive fewer riskless orders and less in commissions on the orders they do receive. When risks begin to outweigh prospective returns, positioners can respond either by positioning stock at increased discounts from previous sales, or by ceasing to position difficult orders altogether. Increased discounts, by definition, impair the price continuity[54] of NYSE markets to the detriment of all investors, at least in stocks in which funds do much of the trading.[55] Some positioners contend that this has already happened.[56] Moreover, since positioning, however frequently done, is usually a fund's last resort when it wishes to sell,[57] positioners' unwillingness to take risks would drastically reduce the liquidity of fund portfolios.[58]

These dangers, and injury to fund shareholders, might be avoided if shareholders could effectively use derivative suits to challenge advisers' brokerage allocation. However, the difficulty of proving misconduct in

52. SPECIAL STUDY, pt. 4, at 216.

53. In a perfect market, at least over time, fund-selling brokers might be expected to acquire brokerage expertise at the insistence of advisers. However, acquiring expertise usually means hiring talented individuals who for many reasons may not be available—for example, they are likely to be partners in firms which specialize in brokering. Moreover, advisers may not insist too strenuously; unlike fund shareholders, they may gain more through fund sales than they lose in faulty executions.

54. A market possessing "price continuity with depth" is one "which moves in small fractions, but in which the specialist stands ready to make reasonable capital commitments at each significant price level." SPECIAL STUDY, pt. 2, at 124. The SPECIAL STUDY, pt. 2, at 126, 162, considered such markets to be in the public interest, because they discourage speculative activity, prevent excessive price fluctuations from destroying the value of securities as collateral, and provide accurate indications of value.

55. Fund trading can be substantial even in the stock of large, broadly-held corporations. *E.g.*, in the last half of 1964, fund *net* purchases accounted for 39.3 per cent of the NYSE trading volume in the shares of Southern Pacific Co. and 34.9 per cent of such volume in the shares of Union Carbide Co. POLICY REPORT 291. The power of fund selling pressure is illustrated in N.Y. Times, Oct. 30, 1969 at 67, col. 8 (city ed.).

56. Industry sources; N.Y. Times, Feb. 22, 1970, sec. 3 at 1, col. 8 (city ed.).

57. Rate Hearings 759, 2481.

58. On the effects of illiquidity, see POLICY REPORT 256 ff.

specific cases makes successful suits unlikely. *Moses v. Burgin*,[59] the only such case to date involving brokerage allocation, was decided on plaintiff's failure of proof. In that case, a fund shareholder alleged, *inter alia*, that the fund's adviser had violated federal common law and § 36 of the unamended Investment Company Act[60] by placing much of the fund's brokerage business with fund-selling and research brokers, thereby failing to secure "best executions" for fund orders. The head of the fund's trading department, who was paid by the adviser, testified that he selected brokers only after investigating their expertise, and that he always checked prices on all exchanges in order to secure best executions. Despite evidence that he occasionally placed orders with inexperienced brokers, the court found that "Neither cross-examination nor independent evidence showed that *in specific transactions* [the fund] could have achieved better executions."[61] Thus, the court found it unnecessary to decide whether a failure to achieve best executions would have violated § 36. It did suggest, however, that the section's proscription of only "gross" abuses of trust acted as a "negative pregnant"[62] to preclude charging defendants with a further fiduciary duty, either under the Act or federal common law.

Whatever the standard of advisers' duty, however, plaintiffs will still face the same problem of proof in future cases. As in *Moses v. Burgin*,[63] defendants will generally testify that, given brokers with equal expertise, they will favor those who sell fund shares. Taken at face value, this could hardly amount to "gross" or any other sort of

59. 316 F. Supp. 31 (D. Mass. 1970).

60. 15 U.S.C. § 80a-35 (1964), which authorized the SEC to seek injunctions against fund directors, advisers and underwriters "guilty . . . of gross misconduct or gross abuse of trust . . . ."

It is doubtful that the plaintiff in *Moses v. Burgin* could bring a similar action under the corresponding sections of the amended Act, Pub. L. No. 91-547 (Dec. 14, 1970). New § 36(b), which becomes effective in June, 1972, Pub. L. No. 91-547, §§ 20, 30(4) (Dec. 14, 1970), grants shareholders a right of action only to challenge the level of advisory fees and similar compensation. New § 36(a), which became effective in December, may be more promising; it empowers the SEC to seek appropriate "injunctive or other relief" against advisers and others engaging "in any act or practice constituting a breach of fiduciary duty involving personal misconduct." However, it is unclear whether "personal misconduct" includes the practices attacked by plaintiff in *Moses v. Burgin*; the legislative documents merely state that the new section "is not intended to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry." SEN. REP. No. 184, 91st Cong., 1st Sess. 16 (1969) [hereinafter cited as SEN. REP. 184]; H.R. REP. No. 1382, 91st Cong., 2d Sess. 37 (1970). Moreover, the provision of § 36(b) which allows private suits "should not be read by implication to affect [§ 36(a)]." SEN. REP. 184 at 16.

61. 316 F. Supp. at 37 (emphasis supplied). The court never decided which party bore the burden of proof, since it found that defendants could have carried "the burden of proving that [the fund] achieved, as a matter of regular practice, best execution." *Id.* at 56.

62. *Id.* at 55.

63. *Id.* at 36-39.

misconduct, for only in the rare case will defendants be unable to show a general correspondence between the prices secured on fund transactions and then-prevailing market prices. The problem is that the execution of a fund order on the NYSE sets the then-prevailing market price; the transaction acquires validity merely because it is effected on the central public exchange. At best, a plaintiff can hope to show that the same security was offered or bid for at a better price, at virtually the same time, on a regional stock exchange. Otherwise he will have to prove that another broker could have secured better executions on the NYSE. Although the latter task is probably harder, both are nearly impossible, for they would require the reconstruction, in minute detail, of market conditions at the time of the challenged executions.

C. *Negotiated Rates*

A proposed SEC regulation affecting NYSE commissions may soon make it easier for plaintiffs to demonstrate that an adviser has not secured best executions. On October 22, the Commission asked the NYSE to eliminate minimum commissions "for that portion of an order in excess of $100,000,"[64] and gave the exchange until June 30 to propose a new commission schedule which included this change. Although the exchange may demand hearings on the matter, the SEC would, after the hearings, have the power to enact the proposal itself,[65] and Commission officials expect[66] that it would do so. It is therefore quite likely that sometime this year, brokers and their customers will be negotiating commission rates for portions of orders in excess of $100,000. The only ground which the SEC cited for its action was that fixed charges above the $100,000 threshold are "unreasonable" and "neither necessary nor appropriate"[67]—a mere invocation of the language of the Exchange Act which authorizes the Commission to make such changes in the rules of a securities exchange as are "necessary and appropriate for the protection of investors . . . ."[68] But whatever the Commission's reasons, its proposal would most clearly affect mutual funds, for the average fund order involves about $149,-

64. Letter from Hamer H. Budge, Chairman of the SEC, to Robert W. Haack, President of the NYSE, October 22, 1970, on file in SEC New York office.

65. *See* note 36 *supra*.

66. N.Y. Times, Oct. 23, 1970 at 69, col. 5 (city ed.).

67. SEC Exchange Act Release No. 9007 (Oct. 22, 1970).

68. *See* note 42 *supra*.

000[69]—three times the average for any other class of institutional investors.[70]

If, as many brokers anticipate,[71] competition drives rates down, fund advisers may find it difficult to reward fund-selling and research brokers. Because of the cost of maintaining sales and research organizations, those brokers may be unable to meet the rates set by brokers whose only business is executing orders. Advisers might well be wary of paying more, since a fund shareholder bringing a derivative action could then easily prove the adviser's failure to secure best executions. Instead of having to show that other brokers could have obtained better prices on the fund's orders, the shareholder could simply prove that the adviser paid unnecessary charges. The adviser would then have to justify his action—a difficult task when the added expense is chargeable to fund sales, somewhat less difficult when chargeable to research.

In contrast, advisers may be willing to pay higher commissions for positioning services. By making it possible for advisers to liquidate large fund holdings, positioners, as noted,[72] absorb part of the transaction costs which the funds would otherwise incur. Positioners have in the past expected to recoup at least some of this expense from commissions on subsequent, riskless orders. But they may be unable to do so if rates on these latter orders decline under competitive pressure. Positioners may therefore charge increased commissions on positioned orders; with this in mind, some positioning firms have reportedly pressed for negotiated rates.[73] Here it would be relatively easy for advisers to justify the added expense. Unlike fund sales or research, positioning is directly related to, and often necessary for, the execution of fund orders. More importantly, positioning does not involve any potential conflicts of interest between advisers and fund shareholders. An adviser's decision to pay increased commissions would merely reflect its business judgment—that market risks would make it more costly to retain the positioned stock. Advisers already make similar judgments when they decide to sell large blocks at sizeable discounts from previous sales.[74]

69. N.Y. Times, Oct. 26, 1970 at 58, col. 1 (city ed.). Since the average fund order is 3, 726 shares and the price of an average NYSE stock is about $40, the average fund order involves about $149,000.

70. N.Y. Times, Apr. 21, 1970 at 61, col. 1 (city ed.).

71. *Id.*, Oct. 26, 1970 at 5, col. 7-8 (city ed.).

72. *See* pp. 376-77 *supra*.

73. N.Y. Times, Oct. 26, 1970 at 58, col. 2-3 (city ed.).

74. As one fund adviser has testified, Rate Hearings 2078-79:

If we think that the stock is going to go down because of certain news, I find that it

Negotiated rates are no panacea, however. Under the SEC proposal, minimum commissions would still be set for the first $100,000 involved in an order, and many fund orders will not exceed that threshold. Indeed, the SEC has approved increased commissions for such orders.[75] Moreover, commissions on the amounts in excess of $100,000[76] might not decline enough to make the handling of large orders wholly unprofitable for fund-selling and research brokers. It is also possible that fund-sellers will be able to meet the new rates while research brokers will not, since the former will continue to receive dealer discounts—now usually 7.1 per cent of the gross amount of fund shares they sell.[77] If so, the new rates might allow advisers to reward fund-sellers, and yet eliminate the more justifiable purchase of research. Whether rates fall or not, then, the latest SEC proposal is unlikely to meet the peculiar problems of the mutual fund industry. Any compromise between the SEC and NYSE on a cut-off figure higher than $100,000 would be even less effective.

IV. Alternative Measures

A. *Controls on Advisory Fees*

Because advisers' practices have survived past changes in the NYSE commission structure and are likely to survive negotiated rates as well, measures aimed directly at these practices will probably be necessary. In particular, the SEC might consider measures which would deprive advisers of their incentive to promote fund sales with fund assets in general, rather than of their ability to promote sales with brokerage commissions. An adviser's greatest incentive, of course, is the prospect of unlimited gain from the sale of fund shares. If the escalator effect tying fees to sales could be checked so that, regardless of fund sales, fees always bore a reasonable relation to advisers' services, advisers' incentive to stimulate fund sales would be greatly diminished. Since the achievement of reasonable advisory fees is one of the goals

is much more advantageous to our stockholders to take a two point concession and sell the stock. In our business . . . information travels very fast and the chances are that if I don't sell the stock, a half hour later somebody else will, and at that time, I will be negotiating two points under the then-price. So the best thing is to negotiate with a [positioner] and see if we can get rid of the block.

75. Letter, *supra* note 64.

76. Advisers would be unlikely to split orders into smaller fragments, because a substantial decrease in the size of a fund's orders would be relatively easy to detect.

77. *See* note 3 *supra*.

of the 1970 amendments[78] to the Investment Company Act of 1940, it would be useful to examine the legislation; it illustrates the possible approaches to the problem of controlling advisory fees and the difficulties entailed.

One part of the new legislation attempts to increase the likelihood of arm's-length bargains between advisers and funds, by strengthening the position of independent fund directors. It requires annual renewal of advisory contracts by a majority of the "uninterested" directors, voting in person at a special meeting called for that purpose.[79] "Interested" directors include not only those "affiliated" under the unamended Act, but also any member of their immediate families, any shareholder of the advisory corporation, anyone affiliated with the fund's or adviser's legal counsel, any registered broker or dealer, and anyone that the SEC determines to be "interested" by reason of a "material business or professional relationship" with the fund or any other fund having the same adviser.[80] In addition, directors are placed under a duty "to request and evaluate"—and advisers "to furnish"—"such information as may reasonably be necessary to evaluate the terms of an [advisory] contract . . . ."[81]

These provisions are unlikely to have much effect on advisory fees, however, as they unduly rely on "uninterested" directors to act independently. In the past, because advisers have generally created their funds, they have appointed the original fund directors, and have retained effective power to select replacements;[82] the 1970 amendments leave this power intact. Advisers will simply have to look harder for congenial "uninterested" directors than they have for "unaffiliated" directors. Like "unaffiliated" directors, "uninterested" directors will generally have other, full-time jobs, and will not be motivated to disrupt relations between board members.[83] Although the amendments require annual approval of the advisory contract by a majority of the "uninterested" directors— shareholder ratification will no longer

78. Pub. L. No. 91-547 (Dec. 14, 1970).
79. *Id.* § 8(c).
80. *Id.* § 2(a)3.
81. *Id.* § 8(c).
82. Although the fund . . . may grow to substantial size, because of the diffusion of share ownership and the absence of organized shareholder participation in fund affairs, the power to select the fund's directors remains with the original organizers or their successors.
POLICY REPORT 130.
83. As the Commission has repeatedly pointed out . . . unaffiliated directors . . . are not in a position to exert any control over advisory fees and in fact have never done so during the thirty years since the Investment Company Act of 1940 was passed.
H.R. REP. No. 1382, 91st Cong., 2d Sess. 86-87 (1970) (SEC memorandum).

suffice—their approval of an unfair contract will subject them to no penalties.[84] Their failure to evaluate information regarding advisory contracts will be hard to detect; and their sources of information regarding fund operations—fund employees and counsel—will, as in the past, generally be paid by the adviser.

Even should the uninterested directors have the information and incentive to give careful scrutiny to the advisory contract, the amendments fail to provide them with a strong position from which to strike an arm's length bargain. As long as the Investment Company Act permits escalator clauses under which advisory fees increase automatically through sales of fund shares, uninterested directors will bear the burden of bargaining for fee reductions. If the Act prohibited escalator clauses and required that advisory contracts set fees in fixed amounts, advisers would at least have to request fee increases on the basis of services performed.

Yet even prohibiting escalator clauses would not give effective bargaining power to the uninterested directors, because their only bargaining weapon, refusal to renew the contract, would be too unwieldy. The most independent director might hesitate before rejecting an adviser's demand for fee increases which he considered excessive, since the adviser's refusal to agree to a contract would leave the fund entirely without a management staff. No adviser would permit the creation of a parallel, internal management staff; and a statute compelling the replacement of external with internal management—even if constitutionally permissible[85]—is not likely to emerge from the Congress in the foreseeable future.[86] The prospect of truly independent directors, able

84. Pub. L. No. 91-547, § 20 (Dec. 14, 1970), has added a § 36(a) to the Investment Company Act, empowering the SEC to sue for the removal of directors and others who have committed a "breach of a fiduciary duty involving personal misconduct;" but this section could not conceivably apply to a director's vote. The action for damages created by new § 36(b), *see* p. 390 *infra*, would run only against the recipients of advisory fees and similar compensation.

85. Such a statute, however desirable, might be a taking of private property under the Fifth Amendment, and therefore forbidden unless coupled with the payment of "just compensation." For thirty years the Investment Company Act has sanctioned external management by advisory corporations, many of which are publicly held. To prohibit external management now would be to make the shares of these corporations valueless, by depriving the corporations of their only income-producing properties, advisory contracts. The statute might therefore have to provide for the purchase of such shares by the government.

86. As the product of three years of lengthy hearings, the new act is likely to be the last legislation regarding mutual funds for some time. Moreover, the depth of commitment to mutual fund reform in the Congress, particularly in the House, is questionable. For example, before it went into conference, the House's version of the new act required plaintiffs to prove a breach of fiduciary duty regarding advisory fees "by clear and convincing evidence." H.R. REP. No. 1631, 91st Cong., 2d Sess. 30 (1970).

to act as a meaningful check on advisory fees, therefore seems distant indeed.

However, the new legislation also relies on a second approach. After advisers and directors have agreed on fees, the legislation measures the figures against a stricter substantive standard than existed under prior law, and grants fund shareholders and the SEC the right to enforce this standard in federal court. In the past, a shareholder could successfully attack fees only if he proved that they evidenced an adviser's "gross misconduct" under § 36 of the Investment Company Act;[87] or, under state law, if he could show that the fees were so excessive as to constitute corporate waste and create a "shocking disparity"[88] between the fees and the adviser's services. The 1970 legislation adds a new § 36(b)[89] to the Act, placing advisers under a "fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature"[90] made by funds to advisers or their affiliates. The SEC can intervene in aid of private suits at any time "prior to final judgment," and plaintiffs in all cases bear "the burden of proving a breach of fiduciary duty."

Unavoidably, the new law illustrates the major problem involved in using derivative suits as a check on advisory fees—the insurmountable difficulty in determining what a reasonable fee would be—since the standard of "fiduciary duty" is equivalent to one of "reasonableness."[91] On what criteria can a court base a decision? The law requires the court to give appropriate weight to board approval or shareholder ratification of the advisory contract;[92] in addition, the legislative documents suggest that the court consider "whether the deliberations of the directors

87. 15 U.S.C. § 80a-35 (1964). Although the section expressly gives only the SEC a right of action, the courts have liberally implied private rights of action under the Act. *See, e.g.*, Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961).

88. Meiselman v. Eberstadt, 39 Del. Ch. 563, 170 A.2d 720 (1961). The cited rule applies only if the defendant proves shareholder ratification of the advisory contract, but this is almost always the case. *Accord*, Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (1962) (flat 0.5 per cent fee on $557 million in assets upheld).

89. Pub. L. No. 91-547, § 20 (Dec. 14, 1970).

90. *Id.*

91. Although neither the act nor the legislative documents accompanying it give content to "fiduciary duty" in this context, the language replaces a "reasonableness" test which appeared in a prior bill, S.34, 91st Cong., 1st Sess. (1969). Since the change of language was motivated only by the desire "to shift the focus of any litigation . . . [from fund directors] to the investment adviser," *Hearings on H.R. 11995* at 189 (remarks of Philip A. Loomis, Jr., SEC general counsel), there is little substantive difference between the two tests. "A breach of fiduciary duty occurs when a fiduciary permits an unfair or excessive charge to be levied on his cestuis." *Hearings on H.R. 11995* at 200 (SEC memorandum).

92. Pub. L. No. 91-547, § 20 (Dec. 14, 1970): "In any such action approval by the board . . . and ratification . . . by the shareholders . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances."

were a matter of substance or a mere formality"[93] and whether the adviser has received payments from other funds.[94] But none of these factors is made controlling,[95] nor should it be if the ultimate test is the reasonableness of the fee itself.

Unless the court picks a standard from thin air, it must eventually compare the fee before it with the range of fees commonly paid for similar services. It might well wish to look outside the mutual fund industry where, as the legislative documents recognize, "the protections of arm's-length bargaining are [more likely to be] present."[96] In almost all cases, however, such an inquiry would be inconclusive, since factors extraneous to mutual funds usually account for differences in management compensation. For example, although banks' fees for managing pension plans, expressed as a percentage of assets managed, average about one-eighth as much as advisory fees, banks often obtain substantial additional income from deposits made under such plans and need not incur the cost of administering them as separate corporate entities.[97]

Only one such comparison could possibly offer the court much guidance—that between the management and operating expenses[98] of externally-managed funds and like expenses of the few funds which are managed by their own officers and directors. According to SEC studies,[99] the former substantially exceed the latter. But a simple comparison of the figures ignores an important fact—as a separate corporate entity, "the adviser is entitled to make a profit."[100] A publicly-held advisory corporation cannot supply its fund with managers and office space at cost, because this would deprive its own shareholders of all prospect of gain. Neither can it reasonably be expected to earn this profit by purchasing managers and office space at a cost lower than what internally-managed funds pay. Thus, if the court were to use the operating costs of internally-managed funds to measure the reasonableness of an ad-

93. S. REP. 184 at 15.
94. *Id.*
95. In theory, the text of § 36(b), note 92 *supra*, might allow the court conclusively to presume fairness from ratification. However, a provision which would have *required* the court to do so was deleted from an early version of H.R. 17333, 91st Cong., 2d Sess. § 8(b) (1970) after SEC criticism, H.R. REP. No. 1382, *supra* note 84, at 86-87, and the SEC has argued that the section's present language "precludes the assertion of a claim of ratification." *Hearings on H.R. 11995* at 188.
96. S. REP. 184 at 5.
97. POLICY REPORT 114-16.
98. Management expenses for internally-managed funds were estimated as the cost of investment management plus the cost of the nonadvisory services which advisers commonly provide in exchange for advisory fees.
99. POLICY REPORT 102-04.
100. S. REP. 184 at 6.

visory fee, it would have to permit a profit margin by adopting a "cost-plus" model. The legislative documents expressly rejected this approach under the 1970 amendments.[101] But if they permitted it, the court would then have to decide how much "plus" was reasonable—and the search for standards would begin again.

The court's only other alternative would be to compare the fee before it with the fees generally paid to other advisers. This would mean that plaintiffs would prevail only against advisers whose fees were substantially higher than industry norms, or who performed substantially fewer services for their funds than other, similarly situated advisers. Indeed, the legislative documents suggest that "the best industry practice will provide a guide."[102] But "industry practice" is not a meaningful standard, because the industry's internal device for restraining fees —the check provided by "uninterested" directors—is illusory.

B. *Segregating Brokerage from Fund Sales*

Given the ineffectiveness of derivative suits and of independent directors as controls on advisory fees or advisers' incentives, the only workable solution would have to follow the SEC's general approach: advisers' *ability* to promote fund sales with brokerage commissions must be curtailed. But this result must be achieved with a measure more direct than those which the Commission has adopted. Brokers could simply be forbidden to execute orders for funds whose shares they sell, or for other funds managed by the same adviser.[103]

Advisers might still engage in more intricate reciprocal practices,[104] but these would be very difficult to conduct on a large scale. In general, advisers would probably allocate most fund orders as they did before give-ups were abolished—to their former lead brokers or to other brokers of similar ability. The proposed measure would therefore result in the better execution of fund orders.[105]

Fund-selling brokers would have to choose between selling the shares of particular funds and competing for their brokerage business. Two major criteria would guide brokers' decisions: their income from fund

101. *Id.*
102. *Id.*
103. The SEC delayed consideration of this measure to evaluate the effects of the abolition of give-ups and the volume discount. POLICY REPORT 188.
104. *E.g.*, an adviser may direct orders to an NYSE broker, on the understanding that the broker will give his over-the-counter business to a fund-seller named by the adviser. Alternatively, the broker might direct orders to a fund-selling firm which belonged to a regional stock exchange.
105. *See* p. 380 *supra*.

sales and brokerage activities, respectively; and their estimates of their own brokerage expertise. There is no reason why brokers could not sell the shares of some funds and execute brokerage orders for others. On the basis of the first criterion, smaller fund-selling firms would be more likely to continue their sales activities, and larger fund-sellers their brokerage activities. Both types of firms usually receive dealer discounts equal to 7.1 per cent of the value of the fund shares they sell, and retain about 3.5 per cent, since one-half of the discount usually goes to the individual salesman.[106] However, smaller fund-sellers usually receive brokerage commissions equal to 1½ or 2 per cent of the value of the shares they sell, while the comparable figures for larger fund-sellers are often 4 to 5 per cent.[107] On the other hand, larger fund-sellers will only cease to sell fund shares if they expect to win about as many brokerage orders with their brokerage expertise as they now do with sales efforts. Since they are assured of dealer discounts on the shares they sell, many of them may be reluctant to abandon their fund sales activities. On the whole, then, advisers may have fewer brokers from which to choose when they allocate brokerage orders. But this is more likely to result in better rather than poorer executions, since the fund-sellers who cease to execute fund orders would generally do so from a lack of confidence in their own brokerage ability.[108]

If there were no restraints on the total sales commissions paid by purchasers of fund shares, brokers who continued to sell shares might successfully demand increased dealer discounts to compensate them for the loss of brokerage commissions. If this occurred, the cost of promoting fund sales with brokerage commissions might merely shift to the purchasers of new shares. Moreover, any rise in sales commissions would be significant, since commissions already average about 9.3 per cent of the value of shares sold—2.2 per cent is retained by the principal underwriter[109] and 7.1 per cent comprises the dealer discount.

But neither dealer discounts nor total sales commissions would be likely to increase very much. For thirty years, §§ 22(a) and (b) of the Investment Company Act[110] have prohibited "unconscionable or grossly excessive" sales commissions, and since § 27(a)(1) has limited sales com-

106. POLICY REPORT 207.

107. *See* note 39 *supra.*

108. Many factors in addition to brokerage expertise may, of course, influence a firm's estimate of its ability to win fund orders. But expertise would probably be the primary factor, since advisers would have little to gain by allocating orders on any other criterion.

109. POLICY REPORT 207.

110. 15 U.S.C. §§ 80a-22(a) and (b) (1964).

missions on installment purchases to 9.89 per cent,[111] advisers and brokers have generally regarded that figure as the maximum conscionable commission for sales in general.[112] Thus, under the unamended act, principal underwriters probably could not raise total sales commissions more than 0.59 per cent; nor could they increase dealer discounts by more than that amount without reducing their own percentages below 2.2 per cent. The recent amendments to the act may inhibit even these increases, for new §§ 22(b)(1) and (2) require sales commissions to be "reasonable" and not "excessive,"[113] and the 9.89 per cent limit on installment purchases is unchanged.[114] Under § 22(b)(1), the SEC may grant "appropriate qualified exemptions" from the "excessiveness" provision to "smaller companies [which] are subject to relatively higher operating costs."[115] But this provision could not authorize the SEC to allow "unconscionable or grossly excessive" sales commissions; in defining this latter standard, the level of sales commissions under the unamended Act will probably be a guide. Fund-selling brokers are therefore unlikely to recoup much of the brokerage commissions they would lose. Some of them may be unable to cover the cost of maintaining sales staffs with the income from dealer discounts alone; the firms in this predicament would be those which have used brokerage commissions to sustain their fund-selling operations. If such firms are also unable to compete effectively for fund brokerage business, they may go out of business entirely, depending on the amount of brokerage business they receive from non-fund customers. But in all likelihood, this is only to say that firms which are both inefficient fund-sellers and inexpert brokers will go out of business.

It is, of course, possible that without the stimulus provided by brokerage commissions, fund sales will substantially decrease. The proposition has never been tested, however, and the dangers involved in doing so are worth the risk.[116] If dealer discounts alone are insufficient to sustain fund-selling brokers, the discounts themselves should be raised. Brokerage commissions should not subsidize fund sales.

111. *See* 15 U.S.C. § 27(a)(1) (1964). The statute limits sales commissions to 9 per cent of the total amount paid by the purchaser; this is equivalent to 9.89 per cent of the value of the shares he receives.
112. No fund charges sales commission in excess of this amount. POLICY REPORT 206.
113. Pub. L. No. 91-547, § 12(a) (Dec. 14, 1970).
114. *Id.* § 16.
115. *Id.* § 12(a).
116. *See* pp. 378-79 *supra.*