4/27 Rec'd 10:20 for today.

Query: 22(d) & should the '40 act be repealed

MEMORANDUM

To: The Commission April 26, 1965

From: Office of General Counsel

Re: Mutual Fund Report to Congress: The Give-up Problem-- Use of Give-ups to reduce Sales Loads.

File

At Commission meetings held last Tuesday and Wednesday, April 20 and 21, 1965, the problem of directed cash give-ups and reciprocals to reward sellers of mutual fund shares was discussed. This memorandum is in response to the request made at the end of the Wednesday meeting that there be prepared a written discussion of the proposals that give-ups now being generated by investment companies as a reward for sales efforts be returned to the investment companies rather than retained by the dealers selling mutual fund shares.

FIRST PROPOSAL: DIRECT REBATE TO THE FUND

The simplest kind of a plan would be one that would allow any investment company to receive a rebate if and to the extent that it could direct a give-up to another member of the exchange on which the transaction was executed or, in the case of the Detroit Stock Exchange, to any member of the NASD. Under this approach the investment companies would be receiving a direct rebate, and implementation would require action under section 19(b) of the Exchange Act to amend the rules of the various exchanges. Action of this sort would also highlight the fact that it would be a benefit available only to investment companies. Justification for the exceptional treatment of investment companies could be made by reference to the fact that it is only in the mutual fund area that the give-up practices presently exist to any substantial degree and presently produce a regulatory problem of any substantial magnitude and that the present give-up practices are nothing more than a disguised volume discount.

If this were done, the various exchanges might simply ban give-ups. If, however, the exchanges did not ban give-ups, investment companies could seemingly not afford not to direct rebates to themselves, as a failure to do so would leave the directors open to shareholder suits for wasting corporate assets. Investment companies could, of course, continue to direct give-ups to others for services directly performed for them, or even for services performed for their adviser, assuming it could be shown that the adviser appropriately reduces its advisory fee in exchange for those services. Reciprocal business would seem to be self-policing to a considerable extent, for if by spreading their business around, the investment companies reduced the give-ups otherwise obtainable, they would be vulnerable in a shareholders' suit for waste, unless a persuasive counterbalancing reason were shown.

As mentioned above, if action of this nature were taken by the Commission, the exchanges might respond by banning give-ups. If give-ups were banned, the question would be whether the Commission would wish to go farther and affirmatively provide that investment companies must be allowed to direct give-ups back to themselves in amounts that are common at the present time (say, up to 60%). The first step under section 19(b) of the Exchange Act could, of course, take this form--that is, the amendment to exchange rules could in the first instance provide that investment companies shall be allowed to direct give-ups back to themselves rather than providing that they will be able to do this only if and to the extent that the exchange rules would permit them to direct give-ups to another member of the exchange.

This approach focuses almost entirely on the rigidity of the exchange commission rate structures and does not directly focus on the excessive selling compensation aspect of the problem. However, one result of the move would be an equalization of the total compensation received for selling fund shares; no longer would NYSE members receive more for that function than other dealers selling fund shares. This is subject to one caveat: If the Commission acted to allow funds to direct give-ups back to themselves to the extent that exchange rules would allow them to direct give-ups to another exchange member and if the exchanges responded by banning give-ups, a fragmentation of fund orders among NYSE members would result in NYSE members receiving more for selling fund shares than nonmembers.

Even if, however, the net result of Commission action were a banning by the exchanges of give-ups, the antitrust problems discussed with the Commission would be ameliorated. The give-up rules are, from an antitrust standpoint, probably the most vulnerable facet of the exchanges' commission rate structure, as there is little rational basis for the give-up practice and the result in the mutual fund sales area is a marked competitive disadvantage for non-NYSE members.

THE SECOND APPROACH: EMPHASIS ON EXCESSIVE SALES LOAD ASPECTS

This approach would view the problem primarily from the standpoint of section 22(c) of the Investment Company Act--"unconscionable or grossly excessive" sales loads. Under this approach the underlying thesis would be that there is some point at which the receipt of compensation for sales effort becomes unconscionable or grossly excessive and that it makes no difference whether this amount is received by the principal underwriter and the contract dealer as "sales load" as defined in the statute or through a combination of "sales load" and other forms such as give-ups for selling effort. Stated another way, the more that is received by a mutual fund dealer, or a principal underwriter for that matter, in give-ups, the smaller the amount of "sales load" that can be received without running afoul of the "unconscionable or grossly excessive" standard of section 22. This approach treats the problem as a mutual fund problem.

Under this approach the Commission would promulgate a rule stating that any amount of statutory sales load ("sales load" as defined in the statute) which either by itself or in combination with directed cash give-ups and compensation for sales activity exceeds (as an example) 9% of the total selling price of the shares is grossly excessive and unconscionable.

In order to make the plan work, it would have to be made applicable to reciprocals for sales effort. This would be done through a formula that would establish a presumption that, say, 60% of the commissions charged by an exchange member for transactions executed on the exchange would be considered a give-up received for sales effort, if the member also sells shares of the fund. Of course, if such a member gives up a portion of the commission to another member, the give-up would reduce the 60%. Furthermore, if it could be shown that the brokerage is in exchange for a service such as supplementary investment advice, the presumption would be overcome. And of course the current practices would act as a measuring rod which could be used to thwart any large-scale attempts of avoidance.

Such a rule would of course have no effect whatever on closed-end investment companies, no-load funds, or any type of institution except mutual funds which presently sell their shares for a statutory sales load close to 9% and which also place their brokerage so as to generate substantial amounts of directed cash give-ups in return for selling effort.

If such a step were taken, the Commission would have in effect limited the reverse type of competition which in recent years has driven the compensation for the sales of mutual fund shares up to higher and higher levels, both in the form of statutory sales load and in the terms of actual total selling compensation, including directed cash give-ups. No fund could sell its shares for more than 9%, regardless of whether it is or is not in a position to generate large amounts of cash give-ups.

Upon the adoption of such a rule, the Commission would make it clear that if a mutual fund wishes to continue to direct cash give-ups to dealers with respect to mutual fund shares sold by them, the Commission would not object, but would simply insist that the total of the statutory sales load and directed cash give-ups for selling effort not exceed 9%. /The 9% figure is of course not necessarily the figure that would be chosen, although it is the figure that has traditionally been used by the Commission over the years as an administrative guide to the maximum that can be charged. It might be that a total lower than 9% should be written into such a rule for larger purchases--a matter discussed in the February 25, 1965 memorandum. The industry does to some extent now offer volume discounts to purchasers, though the breakpoints do not become significant until quite large volumes of purchases are reached./

With this kind of a rule, the directors of funds would of course have open to them the following possibility. They could enter into underwriting agreements which would require the underwriter to execute dealer agreements which would make it clear that the dealer discount must be reduced by the extent to which the give-ups received by that dealer plus the statutory sales load exceed 9% and that if there is any excess, the dealer discount on shares sold by the dealer during the next succeeding periods will be reduced from the schedule in the dealer agreement until the excess is used up. The underwriting agreement would in effect provide that to the extent that the specified dealer discount is reduced because of this special provision, the reduction will be used to increase the price at which the underwriter will purchase the shares from the investment company or to decrease the portion of the sales load allowed to him--in either event resulting in the investment company receiving an amount greater than net asset value for its shares.

This proposal would not result in the reduction of the stated offering price to the public; as mentioned above, the benefits thereunder would go to the fund itself through the sale of some shares at a price in excess of net asset value.

This proposal would fit in rather neatly with existing practice. At present, give-ups given for selling effort are clearly recognized by everyone as additional sales compensation. Complete records on give-ups, and what they are for, are kept by all concerned.

The fund and the underwriter could reach the same result by entering into a special type of underwriting contract and dealer agreement with a few large New York Stock Exchange firms selling considerable amounts of the fund shares. These special agreements would provide for the same public offering price as would prevail in all sales to the public, but would provide for a sale by the fund to the principal underwriter at a price in excess of net asset value and would provide for a sale by the principal underwriter to the contract dealer at a much smaller discount than that allowed to other retailing firms that are not members of the New York Stock Exchange. At the same time the principal underwriter and the fund would guarantee these few dealers that the total amount of sales remuneration received by them would be equal to that received by any other mutual fund retailer, as the fund would ensure that the dealer would receive give-ups in an amount sufficient to make up the difference.

Our rule, or the release accompanying it, would make it clear that it would be perfectly legal to use either of those two methods to make use of give-ups to result in amounts larger than net asset value being received by the fund for the sale of some of its shares. Assuming that dealers were willing to enter into either type of offset arrangement and assuming the NYSE and other exchanges did not construe this as a prohibited "rebate," the directors of a fund selling its shares for a statutory sales load of 9% (or almost 9%) would be wasting corporate assets to the extent that they do not direct give-ups to dealers selling their shares in order to augument the assets of their funds, thus benefiting all shareholders. The effect would be the same as a volume discount, as the extra assets would benefit all shareholders on a pro rata basis.

Again, it should be emphasized that this approach would have no effect on funds selling their shares for, say, a 5% statutory sales load, because even with give-ups, the 9% total would not be reached. This is not necessarily a defect in the proposal, as shareholders who pay a statutory sales load of 5% are in much better shape than those paying 8-9%.

The possible "bugs" in the proposal are obvious. First, would dealers consent to this type of "offset"? This is a hard question. There would be no advantage in their doing so. In most cases, one fund can be sold as well as any other, and the offset arrangement would create bookkeeping problems. Furthermore, the NYSE members would probably not be happy about this sudden reduction in their total remuneration and might try to thwart the plan. This might, however, be overcome by wording the Commission's rule in such a way as to have only 80-90% of give-ups for sales efforts counted in ascertaining whether the 9% total is reached; this would be done on the basis of the extra bookkeeping involved. If this were done, the enticement might be enough to induce NYSE members to enter into the special offset agreement.

If NYSE dealers refused to enter into these offset agreements, the funds and their underwriters and the contract dealers would still be subject to the requirements of the Commission's rule that the total statutory sales load plus give-ups for selling effort not exceed 9%, and everyone would have to abide by that rule. The effect would be that give-ups would, as a practical matter, be abolished.

The other obvious possible "bug" is that the exchanges might consider the special offset underwriting and dealer agreements as vehicles for routing rebates to the funds. Although this approach does concentrate on the excessive sales compensation aspect of the give-up problem, it must be admitted that the differences are primarily differences in form and that the New York Stock Exchange might well say that if any give-up directed to another member decreases the latter's discount on the sale of mutual fund shares, it is a rebate to the mutual fund. Thus, the New York Stock Exchange might ban give-ups that result in the reduction of a recipient member's dealer discount in the sale of mutual fund shares. If so, the end result would again be an abolition of directed give-ups. Of course, exchange characterization of the offset as a rebate would be subject to the Commission's powers under section 19(b) of the Exchange Act to provide otherwise.

It must also be admitted that this proposal would break new ground in its thesis that in determining whether the statutory sales load is grossly excessive or unconscionable, factors other than the difference between the public offering price and the amount received and retained by the fund must be considered. It would appear that section 22(c) would allow that kind of a test to be applied, but it is not certain. Carried one step farther, this principle would seem to dictate that, for example, unreasonable advisory profits of an adviser-underwriter and unreasonable brokerage profits of a broker-underwriter should be considered in determining whether the statutory sales load is grossly excessive or unconscionable. In the broadest sense, this is fair enough, as unreasonable advisory and brokerage profits also come out of shareholders' pockets, just as do grossly excessive sales loads (though the burden of grossly excessive sales loads falls solely on purchasers who are so charged, while unreasonable advisory and brokerage profits fall evenly on all shareholders). The argument that would be advanced against such an approach is that the Commission was purposely given direct controls only over statutory sales loads and that it would be a frustration of the statutory scheme for the Commission to widen its field of vision to look at all compensation and monies paid by investment company shareholders to determine whether the statutory sales load element is too high. This argument is hardly overpowering.

Perhaps another problem with the proposal is how it would work out with respect to a broker-affiliated fund which gives most of its portfolio execution business to the affiliated broker. For example, Dreyfus Fund gives most of its brokerage to Dreyfus, which also acts as its underwriter and adviser. Dreyfus distributes no give-ups for selling fund shares, but instead allows a dealer discount that is 1-1½ percentage points higher than that allowed by most underwriters. Thus, at present, the contract dealers' sole sales remuneration is received out of the statutory sales load. It would appear that the directors of Dreyfus Fund would, if the proposal were adopted, come under pressure to force Dreyfus to give up a portion of its commission to the contract dealers so as to return that portion to the fund. If this were done, Dreyfus would probably bring its share of statutory sales load into line with the usual underwriter's share in the industry. This would have the effect also of bringing the dealer's discount into line.

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