Valicenti Leighton Reid & Pine
New York, NY

March 29, 1968

Office of the Secretary
Securities and Exchange Commission
Washington, D. C. 20549

Dear Sir:

On behalf of Waddell & Reed, Inc., we submit in triplicate a memorandum setting forth their comments on proposed Rule 10b-10.

Very truly yours,

Mitchel J. Valicenti

March 27, 1968

Securities and Exchange Commission
Washington, D. C. 20549

Re: <u>SEC Release No. 8239 under the Securities Exchange Act of 1934; proposed Rule 10b-10</u>

Dear Sirs:

The purpose of this letter is to respond to the invitation for comments on proposed Rule 10b-10 and on the general proposals recently made by the New York Stock Exchange dealing with commission rates and reciprocal business.

<u>Introductory Comments.</u>

The rule-making power granted to the Commission in the Investment Company Act of 1940, in Section 38(a) thereof, contemplates that the Commission shall have authority to make rules which are "necessary or appropriate to the exercise of the powers conferred upon the Commission" by that Act. Similarly, in Section 23(a) of the Securities Exchange Act of 1934, the Commission (and the Board of

Governors of the Federal Reserve System) are given power "to make such rules and regulations as may be necessary for the execution of the functions vested in them by this title." Each of these provisions contemplates the enforcement of existing law, not the making of new law. Yet the proposed rule would create new law and new legal relationships, a point which we will cover more fully hereinafter.

We note that this proposed rule would be adopted under Section 10(b) of the Securities Exchange Act of 1934, and would thus necessarily brand as "manipulative or deceptive" devices or contrivances, practices and procedures which have long-standing acceptance by the securities industry and the Commission and which have been fully disclosed in prospectuses, proxy statements, and elsewhere. Section 10(b) of the Securities Exchange Act of 1934 is a general anti-fraud provision; to characterize long-established practices as fraudulent, even in a proposed rule of prospective application, is, in essence, to indicate that the entire industry is permeated with fraudulent practices and, therefore, with individuals, of dubious morality. This is, of course, directly contrary to the facts, and can only give comfort (whether or not the proposed rule is adopted) to the plaintiffs in impending lawsuits relating to the general area of brokerage and the allocation thereof.

We are disturbed that the proposed rule has even been proposed under Section 10(b) of the Securities Exchange Act of 1934 because the exemptive procedures of the Investment Company Act of 1940 would not be available.

While the proposed rule may have been "under consideration prior to the announcement of the New York Stock Exchange proposal," as set forth in the Release, it most certainly was not under consideration at the time of promulgation of the Commission's Report entitled, "Public Policy Implications of Investment Company Growth." After an exhaustive study of the entire area of give-ups and reciprocals, that Report set forth on pages 184-190 the Commission's then recommendations for actions in this area. There is not even a hint of impropriety therein requiring such drastic action as the proposed rule, but on the contrary, it was clearly stated that the Commission intended to deal with problems in this area through its powers over national securities exchanges and broker-dealers. The only area in which advisers to investment companies were even mentioned was in the general area of fragmentation of orders which might lead to execution of transactions on less than the most favorable basis. In view of this, it is difficult not to draw the conclusion that the promulgation of the proposed rule at this time is a response to the attempt of the New York Stock Exchange, by filing with the Commission vague and interlocking proposals, to place the burden of moving forward in this area on the Commission. The Commission is apparently attempting to place the burden on the mutual fund industry, and not on the New York Stock Exchange where it rightfully belongs.

Absence of Statutory Basis.

To turn to a more specific analysis of the validity of the proposed rule, it is necessary first to examine in detail the statutory provisions under which it is indicated that the proposed rule would be adopted. The first of these is Section 10(b) of the Securities Exchange Act of 1934. This provision relates to "manipulative or deceptive" devices or contrivances. As there is no question whatever of manipulation in this area, it must be that the proposed rule deems activities in this area "deceptive" devices or contrivances. This conclusion is reinforced by the statement in the second paragraph of the Release that the rule be adopted pursuant to the anti-fraud provisions of the Securities Exchange Act of 1934. We do not understand how any course of conduct can be considered as deceptive or fraudulent when it has had long-standing acceptance by the securities industry and the SEC, and when adequate disclosures of the practice have been made in prospectuses and proxy statements of investment companies. We naturally ask: who has been deceived or defrauded? How has he?

The same reasoning applies to the next cited, statutory provisions, namely, Sections 15(c)(1) and (2) of the Securities Exchange Act of 1934. Section 15(c)(1) relates to "manipulative, deceptive or other fraudulent device or contrivance." Section 15(c)(2) relates to "fraudulent, deceptive, or manipulative act or practice." Once again, where is there manipulation, deception or fraud? Furthermore, these cited provisions relate only to brokers and dealers, whereas the proposed rule relates to registered investment companies and their affiliates. No related and equally necessary conduct by a broker or dealer or by other types of investors is indicated by the proposed rule to be unlawful, but only requests by investment companies and affiliates to brokers and dealers are deemed sinful.

The next cited Section is Section 206(4) of the Investment Advisers Act of 1940. This provision relates to acts, practices or courses of business which are "fraudulent, deceptive or manipulative." The Commission is authorized to prescribe rules "reasonably designed to prevent" the same. As there is no proved fraud, deception or manipulation, the proposed rule can hardly be said to be designed to prevent the same. The next cited Section is Section 211(a) of the Investment Advisers Act of 1940, the general rule-making provision under that Act. Such rules must, however, be "necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title." Unless it can be proved that there is fraud, deception or manipulation in this area, to pass the proposed rule would not be within the "powers conferred upon the Commission." It should also be noted that these provisions apply only to investment advisers, whereas the proposed rule by its definition of affiliates covers many types of persons in addition thereto.

The final statutory provisions cited are Sections 38(a) and 17(e) of the Investment Company Act of 1940. Section 38(a) of that Act is the general rule-making power and, once again, grants to the Commission power to make rules "necessary or appropriate to the exercise of powers conferred upon the Commission elsewhere in this title." It is, therefore, necessary to find some other statutory provision in that Act to justify any such rule.

The other statutory provision cited, namely, Section 17(e) of that Act, not only does not support the proposed rule but provides possibly the strongest argument that no such rule is even remotely contemplated by that Act. Section I7(e) specifically permits affiliates of investment companies to receive compensation from investment companies for services rendered in the course of such person's business as an underwriter or broker, and also specifically permits such affiliates acting as brokers to receive brokerage commissions within specified limits. If such affiliates are specifically permitted to receive and retain commissions and compensation, how can it be argued that they are not also permitted to use them in any manner which they deem fit, assuming that neither the investment company nor its shareholders are harmed thereby?

Unsupportable Assumptions.

As we do not find any valid basis for the proposed rule in the cited statutory provisions, it is necessary to turn to the arguments recited in the Release as to the nature of existing problems in this area, and the assumptions contained in the Release underlying such arguments. The Release states that the problems in this area arise out of "certain problems presented by the great increase in institutional investment arid the complex and rapidly developing pattern of practices and procedures in the securities markets associated with that increase which are commonly referred to as 'give-ups and reciprocal business.'" On the contrary, problems, if any, in this area are not caused by such increase or such developing pattern of practices and procedures but, to the extent that problems do exist, they are attributable solely to the commission rate structure of the national securities exchanges and, in particular, that of the New York Stock Exchange, which rate structure obviously produces such excess revenue that member firms readily give up or reciprocate 50% to 75% of their commissions. This matter will be further discussed below in connection with our recommendations for alternative action in this area.

A second assumption which permeates the Release is that there is a fiduciary duty on a mutual fund manager to recapture a portion of brokerage commissions paid by the fund. Not only is this directly contradicted by Section 17(e) of the Investment Company Act of 1940, which specifically permits a broker to retain the full amount within maximum limits, but, as a general proposition, it is totally

insupportable. While the proposed rule purports to apply to all affiliates of registered investment companies, the rule would in fact have an impact principally upon investment advisers of such investment companies. It is the investment adviser who is in almost all cases responsible for the selection of securities for the portfolio of the fund and for the execution of purchase and sale orders for its client.

The relationship between an investment adviser and an investment company is not that of trustee and beneficiary under a strict trust; the relationship is, instead, a contractual one under a type of contract specifically recognized by and regulated by the Investment Company Act of 1940. These contractual arrangements and legal relationships vary from company to company and are by no means uniform. Many investment advisers have specific provisions in their investment advisory contracts relating to the disposition of brokerage, give-ups and reciprocals. The proposed rule would directly contradict these contractual provisions and would limit the right of the Investment company to contract in this area. This to us seems unwarranted, improper, and in conflict with Section 15(a)(1) of the Investment Company Act of 1940.

As to those investment advisers whose investment advisory contracts do not contain such a provision, their responsibilities to their orients are as defined in the contract or as otherwise specifically set forth in the Investment Company Act of 1940. No authority, by case or otherwise, is cited in the Release which would even remotely indicate that the responsibilities of an investment adviser to the fund which it advices extend beyond this; there is not even cited any authority in analogous areas which by implication might give rise to any such responsibility. Again, the true nature of the relationship is not analyzed by the Commission or supported by cited authorities, but an unsupported subjective judgment is made the basis for the proposed rule.

Also underlying the Release and the proposed rule are the unstated assumptions that the use by mutual fund managers of give-ups and reciprocal business for investment information and for sale of fund shares is not beneficial to funds or their shareholders. None of these assumptions is correct, or supported in any way. To achieve best execution on portfolio transactions, it is often necessary to concentrate brokerage among a relatively limited number of brokers of proven ability. As the Commission has already made it quite plain (page 188 of its Report) that fragmentation of brokerage orders is undesirable as possibly not leading to best execution, a mutual fund manager presently has no other practical way to reward investment information or sales other than through the give-up or reciprocal routes established by the exchanges and the securities industry. Cash payments to scores of brokers are not a better solution, but only introduce many new problems.

Discrimination.

We also urge the Commission to consider the serious problem of discrimination raised by the proposed rule. As written, the proposed rule applies only to registered investment companies and their affiliates. It is difficult to take seriously the call for comments on the extension of the proposed rule to other managers of pooled funds, because any attempt to extend such a rule to other managers of pooled funds such as insurance companies, banks and trustees of trusts would be an obvious attempt by the Commission to intrude into areas regulated by other government agencies and the courts. It would also be an attempt by the Commission to transform itself into a body having power not only to create new and unknown "fiduciary" responsibilities, but also the power to enforce the same. In light of these considerations and of the proposed rule as drafted, investment companies and their advisers would necessarily be placed under serious competitive disadvantages, if the proposed rule were adopted, as compared with other managers of securities portfolios, in that competitive managers of pooled funds will continue to have available to them the use of give-ups and reciprocal business for Investment information and other services, while mutual fund managers would no longer be able to use give-ups and reciprocal business to benefit investment companies and their shareholders.

Not only does the proposed rule preserve the practice of give-ups and reciprocals in other areas of the securities industry, but it is discriminatory in the areas to which it purports to apply, in that it penalizes the donee and not the donor.

This to us is curious reasoning and is shaky ground on which to support a fraud rule.

Give-Ups and Reciprocals Provide Indirect Benefits to Mutual Funds.

It is not necessary to discuss the obvious benefits to investment companies and their shareholders which are derived from the availability to their managers of a number of sources of investment information. The benefits to investment companies and their shareholders of additional sales of fund shares are not so immediately obvious but are, nevertheless, very real and important. The relative expense ratios of any investment company necessarily decline as the size of the fund increases; this is especially true where there is a graduated investment advisory fee. Even more important and often overlooked is the fact that the portfolio management responsibilities of any investment adviser are better discharged when a mutual fund is continuously receiving net new money, i.e., an excess of sales over redemptions. The manager is then in a position to take advantage of investment opportunities without necessarily disposing of portfolio positions to meet redemptions, and can concentrate on finding such opportunities

rather than concern himself with the problem of which portfolio securities to dispose of in order to realize cash to meet net redemptions. It is not clear why these important benefits to small shareholders should be wiped out by the Commission without proving there is something patently or inherently fraudulent about give-ups and reciprocals.

Give-Ups and Reciprocals Provide Direct Benefits.

Probably the most serious effect of the proposed rule is that it would completely end the most effective way yet found that directly provides dollars-and-cents benefits to mutual funds and their shareholders by the use of brokerage. These arrangements, which are mentioned with-apparent approval in the Release, relate to mutual fund managers which have created affiliates which have joined a regional stock exchange. Advisory fees paid by their fund clients are then reduced by a portion or all of the net profits of such affiliates.

Despite the apparent, approval by the Commission of these arrangements, the proposed rule would require the total amount of any give-ups or reciprocal business to be paid over to the investment company or used, to reduce fees, even though the affiliated broker performed a necessary and useful function in the transaction, such as clearing or executing, and even though the affiliated broker incurred risk, overhead and income taxes. This consideration was apparently forgotten in drafting the proposed rule, as was the fact that performing various phases of the brokerage function involves costs, responsibilities, risks and tax liabilities.

Even if these problems were to be taken care of by a revision of the proposed rule, the proposed rule would cut the heart out of these arrangements. Once it is granted that best execution is the primary consideration in the allocation of brokerage, mutual fund managers have no choice but to execute the bulk of their transactions in securities listed on the New York Stock Exchange on that exchange, rather than on regional exchanges. It is principally by the use of give-ups and reciprocal business that affiliates which are members of regional stock exchanges derive any substantial degree of profitability and thus pass back substantial dollars-and-cents benefits to mutual funds and their shareholders. The proposed rule would directly injure those mutual funds which have affiliates with membership on regional exchanges, by removing an important source of income.

Allocation and Accounting Difficulties.

Subdivision (b) of the proposed rule raises allocation and accounting difficulties with respect to those affiliated persons who are members of a regional exchange. Our experience is that a great deal of brokerage business comes to our

subsidiary, Kansas City Securities Corporation, where it is impossible to tell whether the business was placed with our subsidiary as reciprocal business for United Funds brokerage, past or prospective, or for some other business reason. The motivation behind, placing the business with our subsidiary is impossible of determination in many cases. It is impractical to base allocating and accounting decision on the subjective thinking of the placer of the business, especially where different motives or reasons for placing the business can be ascribed to a situation. In this respect the proposed rule is particularly burdensome and dangerous for us, as we will constantly live under the threat of violating the rule with all its ensuing penalties, as well as the threat of stockholder litigation.

Proposed Rule Misleading.

The Release states that the proposed rule is based on the premise 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." This is precisely not what would be accomplished by the proposed rule. The proposed rule does not deal with commissions on portfolio transactions, but only with give-ups and reciprocal business relating to such commissions. Quite properly, it does not deal or purport to deal with the execution by affiliates of investment companies of brokerage-transactions for such companies and the retention by such affiliates of the full amount of the brokerage commission. The proposed rule probably does not do so because to do so would be in direct conflict with Section 17(e) of the Investment Company Act of 1940, which specifically permits and regulates such transactions. Section 17(e) thus recognizes what is failed to be recognized by the proposed rule, namely, that the person performing the brokerage function has performed a valuable service and is entitled to be paid therefor. If the broker performing this function is willing, for competitive or other reasons, to reduce the profit to which it would otherwise be entitled by reducing other income to which it or another affiliate is entitled, this is and should remain a matter within its discretion and subject to contract negotiation with the investment company. If the commissions received by brokers are excessive, due to the commission rate structure of the New York Stock Exchange and the other national securities exchanges, this can be effectively solved by the imposition of a volume discount and changes in the rate structure.

New York Stock Exchange Proposals.

The bulk of these proposals, and the presentation of them as a package, is so frankly designed to prevent what the New York Stock Exchange refers to as a "leakage of the commission dollar" as not to require extended comment. However, the fifth proposal, relating to the limitation of membership and broker-

dealer allowances to "bona fide" broker-dealers, is so patently aimed at barring certain broker-dealers as to require comment.

For example, is a firm such as Waddell & Reed, managing a mutual fund, a "bona fide" broker-dealer as the New York Stock Exchange uses that term? If not, Waddell & Reed must be a "bad faith" broker-dealer; yet Waddell & Reed has been registered for over thirty years as a broker-dealer under the Securities Exchange Act of 1934, is registered as a broker-dealer in fifty states, is a member of the National Association of Securities Dealers, and is engaged through a substantial sales force in the distribution of securities. Through its affiliate, Kansas City Securities Corporation, it engages in brokerage transactions on behalf of United Funds, Inc. and the general public on the Pacific Coast Stock Exchange. In view of these considerations, it is difficult to see why Waddell & Reed, Inc. and its affiliate are not "bona fide" broker-dealers, even though a portion of the net profits of Kansas City Securities Corporation is applied by its parent as a credit against the advisory fees payable by United Funds, Inc. If this indirect form of rebate is to be the test as to whether or not a broker-dealer is "bona fide," it will be interesting to see whether, as part of this package, the New York Stock Exchange intends to prohibit the long-standing practice approved by that exchange of permitting its member firms to reduce the advisory fees paid to member firms by their non-investment company clients by a portion of the brokerage generated on such accounts.

None of the New York Stock Exchange proposals should be adopted at this time, except the incorporation of a volume discount in the minimum commission schedule. This should be done not only by the New York Stock Exchange but by all other national securities exchanges and should be done either voluntarily or by Commission action forcing such adoption.

CONCLUSION.

It is respectfully suggested that if there are problems in the area of give-ups and reciprocals, such problems as do exist will largely disappear when the national securities exchanges adopt a volume discount. The imposition of a volume discount would have an immediate, direct beneficial effect on investment companies and their shareholders, as well as other institutional investors, and will greatly diminish if not eliminate give-ups and reciprocals. There are sufficient complexities even in the adoption of a volume discount that need study and solution, without the. introduction of the additional complexities of the proposed SEC rule or of the other proposals of the New York Stock Exchange.

If after the imposition of a volume discount and the study of its effects over a period of time, it appears that, there still remain problems in this area, further consideration could then be given to the solution of any remaining problems.

However, we believe that this relatively simple remedy, aimed at the cause of the give-up practice, will result in the disappearance of all or substantially all problems in this area and v/ill produce immediate dollars-and-cents benefits to all institutional investors and their millions of constituents.

Respectfully submitted,

WADDELL & REED, INC.
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Kansas City, Missouri