MEMORANDUM

February 14, 1966

To: The Commission

From: Division of Corporate Regulation

Re: Disclosure in Proxy Statements and Prospectuses of Practices Followed by Investment Companies in Allocating Brokerage on Portfolio Transactions.

Recommendation:

(1) That the Division be authorized to continue to require disclosure in proxy statements and prospectuses of the practices followed by investment companies in allocating brokerage on portfolio transactions; and

(2) That clarification of the disclosure requirements be made either by amending the rules and forms relating to allocation of brokerage or by issuing an interpretative release.

On July 27, 1965, when it was considering certain aspects of the Mutual Fund Report, the Commission instructed the Division to require investment companies to make disclosure in their prospectuses and proxy statements concerning allocation of brokerage on portfolio transactions. Since that time the Division, in accordance with this instruction, has been sending letters of comment which generally seek to elicit information as to the annual amount of brokerage paid by the fund, the formulas or criteria, if any, which are employed to allocate brokerage (i.e., on the basis of the sale of fund shares or on the basis of services provided, such as research or statistical information); and whether the fund follows the practice of placing its brokerage with a particular broker dealer or group of broker dealers. The comments also suggest disclosure, if applicable, of the approximate value of any services received by the Fund, its adviser, or its managers in return for brokerage. A sample comment is attached.

The Division has attempted to tailor the disclosure to the particular investment company and, where appropriate, has modified the items in the attached list of comments to fit the circumstances, as in the case of closed-end investment companies or "no-load" funds.

At the request of the Investment Company Institute ("ICI"), members of the Division and representatives of the ICI met to discuss this matter on February 2, 1966.[1] At the conference the ICI requested that the Division suspend the sending of any comments in this area (except where an affiliated broker is involved) until the Commission has either (1) adopted appropriate rules which would require such disclosure in prospectuses and proxy statements or (2) issued an appropriate release. Representatives of the ICI requested that, prior to the issuance of any notice of proposed rules or any release, they be given an opportunity to submit comments to the staff as was done in the various stages of drafting Form N-LR.

The ICI states as a basis for its request the following: it is fundamentally unfair to demand that investment companies make disclosure of such a significant nature on an ad hoc, company-by-company basis. Moreover, when a company sends in proxy material, the Division's

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[1] The conferees were:

a. Representing the Division:

Solomon Freedman, Director
Harold V. Lese, Associate Director
J. Arnold Pines, Associate Director
John A. Dudley, Assistant Director
John T. Penland, Branch Chief

b. Representing the ICI:

John R. Baire, Fundamental Investors Inc.
Robert Augenblick, General Counsel, ICI
John Bernard, Massachusetts Investors Trust
Robert Driscoll, Affiliated Fund Inc.
Franklin Johnson, Keystone Custodian Funds

comment concerning brokerage comes to it as a surprise, and it is not generally prepared to make appropriate disclosures within the company's time-table. The ICI states, in effect, that the Division's present procedures place the investment companies "under the gun" since the companies are anxious to have their proxies cleared or their prospectuses become effective.

Although the representatives of ICI generally expressed some difficulty with each of the disclosure areas relating to brokerage allocation, the assignment of a value to the services rendered or given in return for brokerage gives the greatest amount of difficulty.[2] Moreover, they stated that it cannot always be correctly stated how much brokerage commissions may be allocated for services, as against sales reciprocals, because a given broker may (1) provide the best execution, (2) sell fund shares, and (3) also provide services. They further maintained that any such services do not necessarily benefit the adviser, but, rather, that they ultimately benefit the fund shareholders by making available to their adviser supplemental information which, in turn, enables the adviser to perform its functions more effectively. They also advanced the theory that certain of such services may actually create added costs to the adviser because of the time and effort that the adviser may be called upon, needlessly, to review advisory reports or other materials sent in by brokers. The ICI agrees, however, that the bulk of the information which the Division is asking to be disclosed is kept as a matter of course pursuant to the record keeping requirements of Rule 31a-1(b)(9) under the Investment Company Act of 1940.

Generally, it may be argued that the Commission has authority under proxy Rule 14a-9 promulgated under the Securities Exchange Act of 1934 to require brokerage commission disclosures in the absence of an affiliated broker relationship. Rule 14a-9, which is incorporated

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[2] Rule 31a-1 under the Investment Company Act of 1940 does not require a registered investment company, or its investment adviser, to maintain records concerning the monetary value of such services.

into Rule 20a-1 under the Investment Company Act, prohibits the inclusion in a proxy statement of any false or misleading statement with respect to a material fact. Rule 20a-2(a)(1) under the Investment Company Act requires disclosure of the investment adviser's advisory fee and "the amount and purpose of any other material payments by the investment company to the investment adviser." A statement reporting only the investment advisory fees received by the investment adviser implies that that was the total amount paid by the investment company for investment advisory services. If, however, the investment adviser also received certain services from brokers who were being recompensed from brokerage commissions on portfolio transactions of the investment company, this could be deemed to constitute, indirectly, additional payment by the investment company for investment advisory services. In that event, the proxy statement would be misleading as to a material fact in the absence of disclosure of such additional payments.

Form S-5, promulgated under the Securities Act of 1933, requires the prospectus of an open-end investment company to include certain information in Items 22(c) and 33. Item 22(c) calls for a summary of the terms of the advisory agreement, including the basis for determining the remuneration of the investment adviser. If the adviser uses brokerage allocation to obtain investment advice, it would appear that such advice would affect remuneration. Item 33 requires data concerning net underwriting fees and brokerage commissions received by principal underwriters.

Rule 408 under the Securities Act of 1933 requires that there shall be added such further material information as may be necessary to make the required statements in the registration statement, in the light of the circumstances under which they are made, not misleading. Although it is not free from doubt, it seems that additional compensation in the form of

remuneration by way of brokerage commissions or reciprocal benefits may well be required to be disclosed in the prospectus.[3]

Conclusion:

While the Division does not completely agree with the position taken by the ICI, the staff does not object to discussing the matter with the ICI looking towards clarification or modification of the existing forms and rules, or the issuance of an interpretative release. However, inasmuch as we have been tailoring our request for such disclosure to the particular investment company, have not insisted upon unduly strict adherence to the items called for in our letter, and pursuant to the Commission's direction have been requiring such disclosures for approximately six months, we believe that the disclosure requirements in this area should continue during the period we are discussing the matter with the ICI.

The ICI expressed strongly the view that the pertinent forms and rules be clarified or amended if the disclosure requirements are continued, and, if it is determined not to suspend requesting information on the matter of brokerage during the discussion period, the ICI requested the opportunity to present its views orally to the Commission.

Recommendation:

The Division recommends that it be authorized to continue its present policy of requesting disclosure in proxy statements and prospectuses of practices followed by investment companies in allocating brokerage in portfolio transactions. Further, the Division recommends that some formal action be taken which would clarify the disclosure requirements by either amending the relevant rules and forms relating to brokerage allocation or the issuing of a

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[3] See Managed Funds, Incorporated, 39 S.E.C. 313, 325 (1959). It should be noted that allocation of brokerage was apparently not made solely to affiliated brokers.

clarifying release. Prior to the issuance of any proposed rule or release, the Division would confer with representatives of the ICI on the contents thereof.

J.T. Penland
J.A. Dudley
H.V. Lese
J.A. Pines

Disclosure in prospectuses and proxy statements concerning Brokerage

(1) The total dollar amount of brokerage fees paid by the Fund on the purchase and sale of the Fund's portfolio securities in the latest fiscal year;

(2) The formula, method or criteria used in allocating brokerage business to broker-dealer firms engaged in sales of shares of the Fund;

(3) The formula, method or criteria used in allocating brokerage business to broker-dealer firms furnishing statistical, research or other services;

(4) A breakdown of the dollar amount of brokerage commissions for the last fiscal year allocated for the functions described in Items 2 and 3, supra;

(5) The approximate value of the services described in Item 3; a statement that the services are furnished to the adviser; and a statement that to the extent such services are used by the Adviser in rendering investment advice to the Fund, they tend to reduce the adviser's expenses;

(6) A statement whether the Fund intends to allocate brokerage in accordance with the practices described in Items 2 and 3, supra, if these practices would result in the Fund not getting the best price and execution;

(7) If the Fund intends to place portfolio transactions with any particular brokers or dealers or groups thereof, this intention should be disclosed as well as the names thereof.

The foregoing items should be included in the proxy statement and prospectus regardless of whether a Fund uses an affiliated broker, where an affiliated broker is used, however, a statement should be included as to whether a Fund intends to use the services of the affiliated broker if it would result in a Fund not getting the best price and execution. In addition, disclosure should be made of the amount of brokerage commissions received by the affiliated broker during the last fiscal year.