Fidelity Management & Research Company
Boston, Massachusetts

March 29, 1968

Securities and Exchange Commission
Att: Mr. Orval L. DuBois, Secretary
Washington, D. C. 20549

Gentlemen:

We wish to avail ourselves of the opportunity to comment on Securities Exchange Act Release Number 8329 and Rule 10b-10 which it proposes.

At the outset we wish to endorse what we perceive to be the ultimate desire of the Commission (which coincides incidentally with the first proposal of the New York Stock Exchange) for a workable quantity discount. However, we emphatically wish to be recorded as opposed to the method of attacking the problem which proposed Rule 10b-10 adopts. Any meaningful approach to the commission rate structure requires a searching inquiry into the methods and levels chosen. Under the authority granted to the Commission under Section 19(b) of the Securities Exchange Act of 1934, it could hold a public hearing at which members of the financial community as a whole could be heard with respect to the matter. In view of the wide legal and economic ramifications of any such change, this would appear appropriate as the best method of giving all interested parties a chance to be heard.

It is clear that any method of establishing the volume at which a discount should be available cannot be limited to a single broker, or a single exchange, or a single "market place", or a single point in time without severely upsetting the brokerage community as a whole and without endangering the ability of the managers of registered investment companies to execute transactions for the overall best interest of the fund shareholders. The process of arriving at an investment decision should not be artificially influenced by the necessity of placing transactions in a relatively inflexible manner in order to take advantage of a quantity discount. Protection against suits brought with the clarity of hindsight must also be considered where the system has levels of discount, because failure to engage in a transaction, which might result in an overall discount as the result of an investment judgment against the transaction would present problems.

Turning to the rationale advanced as supporting the proposal of Rule 10b-10, we are seriously disturbed by the failure of the release to note several implications of the proposed rule.

First and foremost, the discussion seems to assume that the portion of brokerage commissions which a broker is willing to pass on to another broker at the request of a fund manager belongs to the fund rather than to the broker. There are often brokerage transactions executed on a commission basis as to which a broker refuses to pass on any commission. Certainly every broker would assert that the commission payable for a particular transaction belongs to him and it is in his sole discretion as to whether he wishes, within the limits of the rules of the particular exchange, to honor any request to surrender part of it. Thus, it is rather extraordinary that the release asserts that the willingness of an executing broker to surrender part of his commission on a particular transaction (which willingness would normally be predicated on the hope that he would do more overall business than he otherwise would) to another member of the brokerage community "may constitute acceptance of compensation" by the investment adviser and thus constitute a violation of Section 17(e)(1) of the Investment Company Act of 1940.

The release assumes that 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. After careful investigation it is clear to us that there is no published ruling or statement by any of the major regional exchanges that use of the techniques described in the release as being available for directing commissions to members of the brokerage community do not violate the anti-rebate rules existing on every exchange when employed to reduce, directly or indirectly, the expense of portfolio transactions by a fund. Moreover, an interpretation favoring mutual funds or affiliates of mutual funds over other classes of customers of members of these exchanges would clearly raise serious anti-trust implications. Beyond that, some of the methods described in the release whereby transactions of others are used as a basis for recapture raise serious ethical and non-statutory legal questions.

Assuming that it is possible for a mutual fund manager to recapture part of the commissions and assuming that the fiduciary duty to recapture, an assumption so casually made in the release without, any attempt to show a justification for it, exists, the implication of the discussion and the rule is clear that a mutual fund adviser is not protected unless he maximizes the recapture. Since it is possible to structure the organization of the mutual fund adviser-broker dealer affiliation so that the adviser is a wholly-owned subsidiary of the broker-dealer (e.g., several New York Stock Exchange members with investment company affiliates), and since such a broker-dealer can become a member of every exchange and thereby execute the fund's trades at minimum commissions, the release and the proposed rule could have the-effect of driving independent investment advisers into the brokerage business. If they do not enter it voluntarily, litigation may force them to do so. We do not believe that the Commission intended to promote such a distortion of the existing brokerage community. There is no certainty that the interests of shareholders of the fund would be helped by this development, since it would no longer be possible to conceal the trading activity of the particular group, since it is assumed that most brokerage transactions would have to go through the affiliated broker-dealer. While this may not be prejudicial to the best interests of the shareholders of any funds, the investment moves of a management which has a following among the investment fraternity may result in actions by others which would adversely affect the price obtainable by the fund.

Forcing independent investment adviser groups into the brokerage business would appear, indirectly, to promote exactly the situation which Congress sought to prevent in Section 12 (d)(3) of the Investment Company Act when it prohibited ownership of a broker or dealer by an investment company (except in very limited situations). The inherent conflict between unbiased investment advice and the competitive advantage to be obtained by decreasing the management fee through additional commissions earned in an increased number of transactions is not lessened by having the broker dealer owned by the investment adviser rather than by the investment company.

Turning to the rule itself, it is our opinion that it would foster churning no less and perhaps even more than the Securities and Exchange Commission has alleged in the "Public Policy Implications of Investment Company Growth" with respect to the present situation. The manager of relatively conservative fund A whose policy is gradual long-term growth will be under extreme pressure when the fund's shareholders point out that Fund B, whose policy is maximum appreciation, has reduced the amount of its management fee to nothing by engaging in a sufficient number of transactions to generate the requisite amount of recapturable commissions.

It will also add a new dimension to the problem of determining best price, which may be insuperable, since on every transaction a judgment will have to be made whether a negotiated price or the overall price of a series of transactions on the New York Stock Exchange with no direction will be less than the net effect of placing the transaction in such a way as to direct part of the commission back. Moreover, the rule as proposed would not appear to allow any part of the commissions directed to the investment adviser or its subsidiary to offset expenses incident to maintaining the organization through whose agency the fund expects to benefit.

We are convinced that the use by some of the give up technique to reward a broker who expected to earn commissions on transactions placed through him because of a good research idea, which he did not earn because fund management determined that better execution was available elsewhere, is entirely proper. Brokers are in business to earn commissions, not to do research.

Research is an incidental means of attracting transactions. Where it is no longer possible to reward research while using the third market for execution, the ultimate result will be a drying up of the third market and a reduction of the overall amount of information, available for the benefit of all investors, whether they hold their securities through the medium of an investment company or otherwise.

We also feel that direction of commissions to dealers who have sold shares of the fund is proper, if the broker who executed the transaction is willing to give away part of his commissions. Increased numbers of shares reduce the percentage of total fund costs attributable to each share, especially when the management fee is calculated on a reducing basis. Finally, we feel the rule may both destroy the "third market" and weaken the block positioning NYSE members, because a fund manager, in order to protect himself against law suits and for competitive reasons will have to seek to maximize "commission" business on which a give-up or a reduced commission can be identified and can be passed back to the fund. In looking back it will be difficult for him to prove that a net transaction was a better deal for the fund than a commission transaction with respect to which a cash benefit can be shown. Given the present-day litigious nature of fund shareholders and their lawyers, fund advisers will naturally seek to protect their flanks.

In conclusion we urge that the Commission withdraw both rule 10b-10 as proposed and revise the language in the release and, in the alternative, undertake a comprehensive review of the commission rate structure. Any decision with respect to the proposals of the New York Stock Exchange and with respect to the question of directed commissions necessarily depends on a prior determination of that question.

Very truly yours,

D. George Sullivan
Vice President