IN THE MATTER OF

SECURITY SAVINGS AND LOAN

File No. 3-2511. Promulgated August 25, 1971

Securities Exchange Act of 1934—Section 12(h)

EXEMPTION OF REGISTRATION OF OVER-THE-COUNTER SECURITIES

Where guaranty stock savings and loan association applied for exemption from registration pursuant to Section 12(h) of Securities Exchange Act of 1934, *held*, while broad exemption from requirements imposed on issuer by registration of securities under Section 12(g) not warranted, grant of limited exemption from quarterly reporting requirement not inconsistent with public interest under special circumstances of this case, including absence of regular market for stock, origin and nature of investor interest in issuer, limited income and regulated nature of issuer's business, and existence of other reporting requirements under Act and state regulation to which issuer will be subject.

APPEARANCES:

Edward O. Clarke, Jr. and *P. Dennis Belman*, of Smith, Somerville & Case, for Security Savings and Loan (A Stock Corporation).

Richard H. Rowe and *Alois Lubiejewski*, for the Division of Corporation Finance of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

Security Savings and Loan (A Stock Corporation) applied, pursuant to Section 12(h) of the Securities Exchange Act of 1934 ("Act"), for exemption from the registration, reporting and proxy requirements of Sections 12(g), 13 and 14 of the Act. As pertinent here, Section 12(g), which was added to the Act in 1964, requires an issuer with assets exceeding $1,000,000 and a class of equity security not listed on a national securities exchange and held of record by at least 500 persons to register such security with us. Registration subjects the issuer to the reporting and proxy provisions of Sections 13 and 14 of the Act and its insiders to the insider trading provisions of Section 16. Under Section 12(h) of the Act we may exempt any issuer in whole or in part from Section 12(g) or from Sections 13 or 14,

"upon such terms and conditions and for such period as [we deem] necessary or appropriate," if we find that "by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors."

Following a hearing, the hearing examiner issued an initial decision in which he concluded it would not be consistent with the public interest and the protection of investors to grant an exemption from the registration, reporting and proxy requirements as requested, but that an exemption from the requirements of Rule 13a–13 under Section 13(a)(2) of the Act to file quarterly reports would be appropriate if other requirements are complied with. On the petition of our Division of Corporation Finance ("Division"), we undertook review of the examiner's grant of the limited exemption, and briefs were filed by the Division and applicant. Our findings are based upon an independent review of the record.

Applicant is incorporated in Maryland as a guaranty stock savings and loan institution with two classes of stock: free shares represented by the withdrawable savings accounts of the holders of such shares; and guaranty stock, which provides a secondary reserve for the payment of losses. Upon liquidation the guaranty stockholders are entitled to the undivided profits and reserves after required payments have been made to the free shareholders. Applicant is subject to regulation by the Maryland Department of Licensing and Regulation ("Department") and by the Maryland Savings-Share Insurance Corporation ("Insurance Corporation"), a quasi-public nonprofit corporation created under Maryland law to insure the free-share accounts of member savings and loan associations. As of February 28, 1970, applicant had assets of $8,023,235, liabilities of $7,317,698 including savings accounts of $6,647,-730, and reserves and stockholders' equity of $705,537. For the year ending that date it had gross operating income of $446,888 and net income, after dividends on savings accounts and federal income taxes, of $16,988.

Between March 1968 and September 1969, applicant merged with three mutual savings or building and loan associations which had only free shares that were entitled, upon liquidation, to the undivided profits and reserves. In each merger, the free shares or savings accounts in the mutual associations were exchanged for equal shares or savings accounts in appli-

cant and, as required by the Department, guaranty stock was also issued by applicant for distribution to the free shareholders or accountholders of the mutual associations representing the undivided profits and reserves in such associations. No other guaranty shares have been issued since March 1968. As a result of those mergers 1,360 persons received 46,603 guaranty shares in applicant, which prior to March 1, 1968 had only 85 guaranty stockholders. As of July 1, 1970 applicant had outstanding 113,145 guaranty shares which were held of record by 1,376 stockholders, of whom 878 held up to 25 shares each, 329 from over 25 to 100, 146 from over 100 to 500, and 23 over 500 shares each, with officers and directors as a group owning 40,598 shares or 36 percent of such shares.

The guaranty shares of applicant are not listed on any exchange nor are they regularly traded in the over-the-counter market. The National Stock Summary lists only four bid and one ask quotations for such stock for the period October 1, 1969 to October 1, 1970. Quotations for the stock published in a Baltimore newspaper were discontinued at the request of applicant which felt that because of a lack of transactions such quotations did not reflect the value of the stock. From March 1968 through June 1970 a total of 107 sales, involving 12,117, shares, were effected.

Registration under Section 12(g) entails the filing of specified information and certified financial data in compliance with our Regulation S-X consisting of a balance sheet and statements of profit and loss and of source and application of funds. Such information is required to be kept current by the filing of various reports provided for by Section 13 of the Act and our rules thereunder. Annual reports, on Form 10–K, include up-dated certified financial documents, and a report, on Form 8–K, is required with respect to events specified in that Form within ten days after the month in which they occurred, and requires certified financial statements for any business acquired by registrant representing a significant amount of assets. A further quarterly report, on Form 10–Q, which is the one the examiner would exempt applicant from filing, was recently adopted to replace a semi-annual report (Form 9–K) and to provide more detailed financial information, as part of a program to improve disclosure under the Act.[1] That report calls for the disclosure of financial information, which need not be certified, with respect to, among other things, gross sales, operating revenues, costs and expenses, income, debt, stock, retained earnings and dividends.

[1] See Securities Exchange Act Releases Nos. 8683 and 9004 (September 15, 1969 and October 28, 1970).

Applicant urges that compliance by it with the quarterly reporting requirements would be unduly burdensome particularly in view of its small net income, and that its activities are subject to regulation under Maryland law which affords investors in its quaranty stock protection through, among other things, requirements for the disclosure of financial information of the type provided by the Form 10-Q reports. We have considered the application for exemption in the light of the public interest in having publicly held companies make prompt and accurate disclosure of information to securityholders and the investing public.[2] While a broad exemption from the requirements imposed by virtue of Section 12(g) would not be warranted, we have concluded under the special circumstances it would not be inconsistent with the public interest and the protection of investors to exempt applicant from filing quarterly financial reports under Rule 13a-13 under Section 13(a) (2) of the Act. In reaching this conclusion, we have considered, among other factors, the absence of a regular market for the quaranty stock, the relatively small number of transactions effected, the origin and nature of a substantial portion of the public investor interest, applicant's limited income and the state regulation to which it is subject. We have also taken into consideration that the granting of this limited exemption will not deprive applicant's existing and potential guaranty shareholders of the principal protections provided through registration under Section 12(g) of the Act.[3]

Applicant will still be subject to the reporting requirements of Rules 13a-1 and 13a-11, and must therefore file an annual report on Form 10-K which includes certified financial statements, and current reports of specified events on Form 8-K including a certain situations certified financial statements. In addition, as noted above, the registration of the guaranty stock under Section 12(g) subjects applicant to the proxy provisions of Section 14. Our proxy rules and regulations thereunder require an issuer soliciting proxies from its stockholders to make disclosure to them, through a proxy statement which is filed with us and examined by our staff prior to its use, of relevant facts to insure a vote on an informed basis. In general, if the solicitation relates to the election of directors, a proxy statement must be accompanied or preceded by an annual report containing certified financial statements reflecting the issuer's financial position and results of operations.

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[2] See, *e.g.*, Securities Exchange Act Release No. 8995 (October 15, 1970).

[3] *Cf. The National Dollar Stores, Ltd.*, 43 S.E.C. 881 (1968).

Prior to any stockholders' meeting as to which an issuer does not solicit proxies, it must transmit to its stockholders and file with us a statement containing substantially equivalent information to that required in a proxy solicitation statement, and, if directors are to be elected, an annual report containing the certified financial statements referred to above with respect to the solicitation of proxies.

In addition, the regulation and examination by Maryland regulatory authorities to which applicant is subject includes requirements that it submit a statement of its financial condition in a prescribed form at its annual shareholders' meeting, file a certified copy of such statement with the Department, and deliver a statement of condition to any shareholder upon request; and file a certified statement with the Department, which is available to free shareholders upon request, relating to the salaries, fees and expenses paid to its officers and directors.

While Section 12(g) (2) (C), in exempting from registration any security issued by a savings and loan association supervised by any Federal or State authority, excepts guaranty stock or other similar certificate evidencing nonwithdrawable capital, we do not consider this rejection of an automatic blanket exemption for guaranty stock of such institutions to preclude the grant of a specific exemption to an individual association in a particular case pursuant to the broad authority in Section 12(h) to exempt any issuer in whole or in part from the provisions of Sections 12(g), 13 or 14. At the same time, we emphasize that our decision in this case is strictly limited to the facts and circumstances presented by the record herein.

Our order will require applicant to inform us annually of all sales that have been effected in its guaranty stock and to advise us promptly of any material change in the facts recited in this opinion, and we will reserve jurisdiction to reconsider the exemption in the event of such a change, or in the event that changes take place in our rules and regulations relating to disclosures by Section 12(g) companies.

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM and HERLONG), Commissioner LOOMIS not participating.

IN THE MATTER OF

FIRST MULTIFUND OF AMERICA, INC.

and

FIRST MULTIFUND ADVISORY CORPORATION

File No. 3-2260. Promulgated August 26, 1971

Investment Company Act of 1940—Section 17

APPLICATION FOR DECLARATORY ORDER

Capacity of Affiliate of Investment Company in Executing Portfolio Purchases of Mutual Fund Shares

Retainability and Computation of Concessions on Portfolio Purchases of Mutual Fund Shares

Where registered investment company's investment advisor, which is also registered broker-dealer, effects purchases for company's portfolio of mutual fund shares of other investment companies on which it receives concessions from underwriters of selling companies not exceeding 1 percent of purchase price, *held*, adviser acts as broker for affiliated investment company within meaning of Section 17(e) (2) of Investment Company Act of 1940, notwithstanding selling agreements between it and underwriters of selling companies characterizing it as a dealer, and is entitled to receive and retain such concessions, computed on basis of aggregate purchases without regard to intervening redemptions; but where purchases are effected in which concessions exceed 1 percent limitation in Section 17(e) (2) of Act, *held*, adviser breaches its fiduciary duty to investment company and must pay entire concession to such company, unless purchases are effected in good faith belief that breakpoint resulting in concession not exceeding 1 percent would be reached, in which event excess over 1 percent must be returned to principal underwriter of portfolio fund shares.

Excessive Portfolio Turnover

Where portfolio transactions of registered investment company which invests solely in shares of other investment companies showed high turnover rate, but evidence failed to establish that investment adviser, who as registered broker-dealer effected transactions, induced turnover for purpose of generating concessions for itself, *held*, adviser was not shown to have breached fiduciary duty to investment company and is entitled to retain concessions which were otherwise permissible.

Practice and Procedure

Contentions by applicants that they were entitled to formal responsive pleading by staff, and that Commission's order for hearing was improperly based on *ex parte* communication from staff and raised issues not posed by application for declaratory order, *rejected*.

APPEARANCES:

Simon H. Rifkind, Paul J. Newlon, and *Leonard H. Becker,* of Paul, Weiss, Goldberg, Rifkind, Wharton & Garrison, for First Multifund of America, Inc.

Kenneth J. Bialkin, Louis A. Craco, and *Richard Darsky,* of Willkie Farr & Gallagher, for First Multifund Advisory Corp.

Lloyd J. Derrickson, Frank J. Wilson, John F. Mylod, Jr., and *John J. McCarthy, Jr.,* for the National Association of Securities Dealers, Inc.

Solomon Freedman, Sydney H. Mendelsohn, Gerald Osheroff, and *Stephen K. Wiseman,* for the Division of Corporate Regulation of the Commission.

FINDINGS AND OPINION OF THE COMMISSION

First Multifund of America, Inc. ("Fund"), which is registered as an open-end diversified investment company under the Investment Company Act of 1940 and invests solely in shares of other open-end investment companies, and its affiliate, First Multifund Advisory Corp. ("Adviser"), which is Fund's investment adviser, a registered broker-dealer, and distributor of Fund's shares,[1] filed a joint application for a declaratory order pursuant to Section 5(d) of the Administrative Procedure Act.[2] They seek an order declaring that it is lawful, in accordance with Section 26 of Article III of the Rules of Fair Practice ("Rule 26") of the National Association of Securities Dealers, Inc. ("NASD"), for members of the NASD who are underwriters of the shares of open-end investment companies ("mutual funds") to grant concessions to members who act as brokers for purchasers of such shares, including brokers who are affiliated persons of such purchasers.[3] We ordered a hearing on the application with respect to certain

[1] The president of Fund is also the president and majority stockholder of Adviser.

[2] 5 U.S.C. 554(e). That Section provides that "The agency, with like effect as in the case of other orders, and in its sound discretion, may issue a declaratory order to terminate a controversy or remove uncertainty."

[3] Rule 26(c) permits a broker or dealer who is an NASD member to purchase mutual fund shares at a discount from the public offering price from an underwriter who is also a member, provided that a sales agreement setting forth the concession to be received is in effect between the parties.

matters presented for consideration by our Division of Corporate Regulation ("Division"). A public hearing was held at which the NASD was granted leave to be heard. An initial decision by the hearing examiner was waived, briefs were filed by applicants, the NASD, and the Division, and we heard oral argument. Our findings are based upon an independent review of the record.

The application alleges that at November 21, 1969, Fund had 1,814,607 shares outstanding and net assets of $17,559,964; that Adviser, in purchasing mutual fund shares for Fund from principal underwriters of those shares, receives concessions of not more than 1 percent of the purchase price; and that a controversy had developed between applicants and the Division with respect to the capacity in which Adviser acts in effecting such purchases, the provisions of the Act that are applicable, and whether Adviser or Fund is entitled to the concessions paid on those purchases.

Where a sales load is charged by a mutual fund whose shares Fund proposes to acquire for its portfolio, Fund's practice is to execute a "letter of intent" for the principal underwriter of the selling fund stating an intention to purchase the dollar amount of such shares, generally ranging from $200,000 to $1,000,000, required to qualify it for the minimum sales load, usually 1 percent of the purchase price.[4] Adviser enters into a selling agreement with the underwriter under which it is entitled to receive as a concession or commission an amount normally somewhat less than 1 percent of the purchase price if Fund fulfills its letter of intent. Pending resolution of the dispute between applicants and our staff as to the disposition of those commissions, they have been placed in escrow, and by November 30, 1969, totalled about $279,000.

ADVISER'S CAPACITY IN PORTFOLIO TRANSACTIONS

Applicants assert that Adviser acts as a broker for Fund in effecting purchases of mutual fund shares for Fund's portfolio, while the Division contends that Adviser acts as a dealer and thereby violates Section 17(a)(1) of the Act unless it obtains an exemption from that Section.[5] The Division stresses that Ad-

[4] The letters of intent permit the aggregation of purchases of redeemable securities during a maximum period of 13 months in determining the amount of sales load. There is no obligation to purchase, and, if the letter of intent is not fulfilled, the sales load applicable to the lesser aggregate amount of securities purchased is payable in accordance with a scale of reducing loads varying with the quantity of securities purchased.

[5] Section 17(a)(1) of the Act makes it unlawful for an affiliated person of a registered investment company, acting as principal, knowingly to sell any security to such company, with certain exceptions not here applicable.

viser is characterized as a dealer-principal in the selling agreements with the principal underwriters of the selling funds and that Section 22(d) makes no provision for the sale of mutual fund shares to a broker at a discount,[6] and it argues that while Rule 26 states that brokers as well as dealers may obtain concessions, it cannot contravene Section 22(d). The NASD's position is that Adviser acts as a dealer, as stated in the selling agreements, and can properly obtain the concessions since both Rule 26 and Section 22(d) permit dealers to obtain a concession.

We agree with applicants' position that Adviser acts as a broker. The selling agreements with the underwriters, not all of which refer to Adviser solely as a dealer or principal,[7] govern the legal relationship between Adviser and those underwriters and the selling funds, but not that between Adviser and Fund. The agreement forms are prepared by the underwriters to insulate them and the selling funds from liability for any misrepresentations by the broker-dealer to purchasers and to insure payment by him. Applying the classical common law test of intention of the parties in determining whether an agency relationship exists, the testimony of the president of applicants that it was understood that Adviser acted as broker must be given weight. Moreover, the letters of intent, confirmations, and other materials indicate that Fund, not Adviser, is the purchaser, and that Adviser performs only the functions of a broker.[8] Adviser's rights are therefore governed, not by Section 17(a)(1), but by Section 17(e)(2) which permits it to receive compensation for acting as broker, notwithstanding its affiliation with Fund, provided such compensation does not exceed 1 percent of the purchase price.[9] And Section 17(e)(2) recognizes, in permitting a 1 percent concession, that the performance of certain functions by an affiliated broker may

[6] Section 22(d) of the Act provides in pertinent part that no principal underwriter shall sell mutual funds shares "to any person except a dealer, a principal underwriter or the issuer, except at a current public offering price described in the prospectus."

[7] Two of the selling agreement forms in the record recognized that the purchaser from the principal underwriter may be either a broker or dealer. In one the underwriter states: "You agree to purchase shares through us at the offering price then in effect as agent for your customers or for resale to your customers as principal." In the other it states: "You agree not to purchase as principal, or to participate as broker in the purchase of, any Fund shares except through or from us or from investors . . ."

[8] According to the president of applicants, the confirmations from underwriters to applicants showed Fund to be the purchaser. An official of a company which managed a number of the portfolio funds also testified that when Fund executed a letter of intent, the principal underwriter knew that Fund was the ultimate purchaser and that, "in a sense," the sale was by the underwriter to Fund.

[9] Section 17(e) (2) (C) of the Act makes it unlawful for an affiliated person of a registered investment company "acting as broker" in connection with the sale of securities to such company, to receive from any source a commission or other remuneration which exceeds 1 percent of the purchase price.

be in the interests of the fund despite inherent conflicts of interest.[10]

Our conclusion that Adviser acts as broker is not precluded by the absence of any reference to brokers in Section 22(d) of the Act. That Section, which is primarily concerned with price maintenance, did not need to mention the broker because, if a broker is involved, the sale, as recognized by Section 17(e)(2), is effected through him to the customer (in this case, Fund) who pays the current public offering price as required by Section 22(d). The exception as to a dealer was necessary because, like a customer, he purchases for his own account, and it was intended that he not be required to pay the offering price. Rule 26, which expressly deals with concessions, makes explicit with respect to a broker what is implicit in Section 22(d), namely, that a broker may receive a concession, and, therefore, we see no inconsistency between the two provisions.

We disagree with the Division's further contention that, assuming Adviser is not a dealer, it is not "acting" as a broker within the meaning of Section 17(e)(2), and that Rule 26 cannot validate violations of that Section. The Division asserts that the only function performed by Adviser is telephoning the underwriter and ordering the number of shares requested by Fund at the effective offering price, there being no opportunity to shop for best price and execution, and it points out that Adviser is already compensated for its investment advisory function of selecting suitable investments and that Fund could order the shares directly. However, Adviser's functions include arranging for the letters of intent, sending confirmations to Fund, Fund's custodian, and the underwriter, arranging for prompt payment by the custodian and for receipt by it of the certificate from the underwriter, and record-keeping. Adviser's role as a broker is no different from that of a non-affiliated broker who is asked by a mutual fund to purchase specified mutual fund shares or that of any broker, affiliated or not, who effects a transaction in a listed security for such fund in an ordinary stock exchange transaction. Accordingly, no different characterization should be applied to the functions performed by Adviser because it is affiliated with Fund, or because

[10] In our *Report on the Public Policy Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess., p. 190 (1966), we stated: "The Act deals with these problems [resulting from close affiliation between a broker-dealer and an investment company] by placing some limitations on the type and amount of compensation that broker-dealers may obtain from executing profolio transactions for their affiliated comapnies. In addition, and even more important, are the basic fiduciary standards incorporated in the Act which govern relationships between investment companies and affiliated broker-dealers."

mutual fund shares rather than listed shares are involved and selling agreements are used for the protection of the selling underwriter and issuer.

COMPUTATION AND RETAINABILITY OF CONCESSIONS

The Division next asserts that even if Adviser be considered to be acting as broker within the meaning of Section 17(e)(2), its commissions in fact exceeded in the case of purchases of some of the portfolio fund shares the 1 percent limitation specified in that Section because succeeding purchases, redemptions, and repurchases of shares of the same funds within the period of a letter of intent had the effect of increasing the true commissions paid to Adviser in relation to the net number of shares purchased.[11] We are of the view that, aside from any breach of Adviser's fiduciary obligation to Fund involved in assertedly excessive redemptions and repurchases to generate commissions, which is discussed below, it is not appropriate to calculate the commissions paid to Adviser on the basis of net purchases. Section 17(e))2) states the permissible commission in terms of the price in each transaction. Moreover, Rule 22d–1(a)(3) under the Act permits the aggregation of purchases during the period of a letter of intent, without deduction of redemptions, in determining eligibility for a reduced sales load.[12] Accordingly, it would appear that the computation of commissions on the basis of each purchase is equally permissible. The Division's formula for computing commissions would create uncertainty in achieving compliance with the 1 percent limitation and could discourage redemptions that might be dictated by legitimate market considerations. It could, for example, have the unwarranted result of requiring Adviser to relinquish all commissions received with respect to purchases of shares of a fund which were thereafter redeemed for sound reasons during the period of the letter of intent.

We are also not persuaded by the Division's contention that Adviser must pay over to Fund all the commissions it receives on the ground that their retention is inconsistent with Adviser's fiduciary obligation to Fund to obtain the best price and execution. In the face of Section 17(e)(2) as well as Section 22(d), we do not consider that Adviser has any fiduciary

[11] Although the Division analyzed transactions in shares of 11 portfolio funds, its argument is not pertinent with respect to at least five of such funds, as to which it appears that Fund effected a series of consecutive purchases, without any intervening redemptions, sufficient to qualify it for a 1 percent load under the letters of intent.

[12] The general practice of the industry is for selling funds to permit the aggregation of purchases without deducting redemptions in determining whether the letter of intent has been fulfilled.

obligation to turn such commissions over to Fund.[13] As pointed out by Adviser, and recognized by Fund, retention of the commissions paid to Adviser "affords a benefit to the Adviser which the Fund may properly take into account in bargaining with the Adviser concerning its advisory fee." We would anticipate that substantial recognition would be given to the commissions retained by Adviser, with of course appropriate allowance being made for the expenses incurred in executing portfolio transactions for Fund.[14]

The record discloses several instances, however, where Adviser's commission exceeded 1 percent of the purchase price, in violation of Section 17(e)(2). On four purchases of the shares of First Investors Fund for Growth, Adviser's concessions amounted to 1.15 percent of the purchase price, and on at least two purchases of the shares of Hartwell and Campbell Leverage Fund, Adviser's concessions amounted to 1.2 percent and 1.6 percent of the purchase price. In those instances Adviser must be considered to have breached its fiduciary duty to Fund to the extent that it effected transactions at commissions which exceeded 1 percent; and, therefore, it must pay the entire amount of such commissions to Fund, no exemption from Section 22(d) is necessary for this purpose, and Section 24 of Article III of the NASD's rules, which prohibits concessions to anyone other than a broker or dealer, is not pertinent.[15] With respect to two purchases of Oppenheimer Fund shares pursuant to Fund's letter of intent expiring in November 1968, it appears that Adviser effected purchases in good faith belief that the breakpoint resulting in a concession to Adviser not exceeding 1 percent would be reached; in fact, the letter of intent was not fulfilled and the concession exceeded 1 percent. We would consider the provisions of Section 17(e)(2) satisfied if the excess commission over 1 percent in each of these two

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[13] See *Kurach* v. *Weissman*, 49 F.R.D. 304, 307 (S.D.N.Y. 1970).

In view of our conclusion, we reject the Division's ancillary argument which applicants and the NASD opposed that we should exempt Adviser from Section 22(d) pursuant to Section 6(c) so as to enable it to effect the payment to Fund.

[14] In our Investment Company Report (*supra*, at p. 190), we recommended that brokerage commissions paid to broker-dealers with which investment company managers are affiliated be taken into account for the purpose of reducing management cost. We stated: "If Congress accepts this recommendation, affiliation between investment companies and broker-dealers should in the future produce significant benefits to investment companies and their public shareholders in the form of reduced management costs." See Section 36(b), added by 1970 Amendments and effective June 1972 (Public Law 91-547, Sec. 20, 84 Stat. 1429).

[15] *Cf. Provident Management Corporation*, 44 S.E.C. 440, 445 n. 14 (1970).

transactions were returned to the principal underwriter of the selling fund.[16]

ALLEGED EXCESSIVE PORTFOLIO TURNOVER

The Division contends that once Adviser commenced receiving concessions on transactions for Fund, it increased the rate of such transactions excessively in order to generate concessions. It notes that a significant number of dealer agreements (permitting the payment of concessions to Adviser) were signed by Adviser late in 1968 and throughout 1969, and that for the year ended November 30, 1969, Fund reported a portfolio turnover rate of 253.1 percent, as compared to 76.8 percent reported for the previous year.[17] The Division alleges that Adviser followed a practice of purchasing, redeeming, and repurchasing shares of the same funds, and of redeeming all or a large part of the investment in a fund shortly before and after expiration of the letter of intent and re-using the proceeds to purchase shares in other funds. It urges that to redeem shares in one fund and repurchase shares in another "virtually simultaneously" affords little benefit to the investor since each fund is itself invested in a large number of companies, and that Adviser's practice was to switch to funds with substantially similar investment objectives.

In our opinion the record does not establish by a preponderance of the evidence that Adviser induced the turnover in Fund's portfolio for the purpose of generating commissions. We note at the outset that the Division's charge of excessive transactions was based on an analysis of only 11 of Fund's 70 portfolio securities, which were not claimed to be representative of all the others but rather selected as showing "particularly heavy" trading. As previously mentioned, purchases sufficient to qualify for the 1 percent load were effected in at least five of the 11 portfolio funds without any intervening redemptions.[18] Moreover, there appears to be no material difference in

[16] Under the investment advisory agreement between Adviser and Fund, Adviser was required to reimburse Fund for any sales load in excess of 3½ percent (now 2½ percent) of the purchase price. It appears that reimbursements were made, pursuant to this guarantee, in an amount that applicants' president states has been insignificant, which may involve questions under Section 22(d). We note that no reimbursements were necessary with respect to Fund's purchases of the protfolio funds selected for analysis by the Division.

[17] Of the approximately $279,000 in escrow at November 30, 1969, $249,158 was credited to Adviser during the year ending on that date.

Under the instructions in Form N-1R filed by Fund, the portfolio turnover rate is calculated by dividing the lesser of the dollar amounts of the purchases and the sales of portfolio securities for the fiscal year, by the monthly average of the value of the portfolio securities owned by registrant during the year computed according to a specified formula.

[18] In three of the remaining six portfolio funds, over 75 percent of the qualifying amount had been invested before any redemptions.

the pattern of transactions as between those five funds and the remaining six, or between those purchases on which Adviser received concessions and those on which it did not. We also note that, whatever significance with respect to the volume of commissions Fund's 1969 turnover rate might have in the case of a conventional mutual fund which pays a commission on both the purchase and sale of its portfolio securities,[19] the computation of the turnover rate here did not exclude transactions entailing no commissions to Adviser, including sales (redemptions), transactions in no-load funds in which about a third of Fund's assets were invested, and those involving a switch between funds in the same management complex which similarly were made at no sales load.[20]

As we analyze Fund's repurchases following redemptions in the 11 selected funds, they do not establish that Adviser was seeking increased commissions. For example, Fund, to qualify for a 1 percent sales load on purchases from L. M. Rosenthal Fund, had to purchase $500,000 of its shares. In January and February 1969, Fund purchased 34,000 shares at offering prices ranging from $10.87 to $11.13 per share for a total of $372,920. Ten days later, Fund redeemed 31,000 shares at about $9.85 per share for a total of $305,620. About a year later, within the 13-month period of the letter of intent, Fund purchased 18,000 shares, at $7.43 per share, for $133,740. Assuming no redemptions or repurchases had been made, since the $372,920 of purchases were below the breakpoint for a 1 percent load, Fund would have had to pay a sales load of 2.03 percent or $7,570 and Adviser's concessions under the selling agreement would have been 1.71 percent or $6,377. By making the repurchase in the amount of $133,740 following the redemptions, the total sales load paid by Fund on the aggregate purchases of $506,660 amounted to $5,067, and the commissions actually payable to Adviser amounted to $4,509. Similarly, in connection with Fund's transactions in the shares of Boston Common Stock Fund, where $1,000,000 in aggregate purchases was required to qualify for the minimum sales load of 1 percent, Fund first effected purchases of $843,750 on which, absent further purchases, a sales load of 2.25 percent or

[19] In 1969, about 8 percent of 370 conventional mutual funds which submitted reports to us had turnover rates higher than Fund, and in 1968 about 35 percent of 404 reporting funds had higher rates than Fund.

[20] Of the 148 transactions reflected in the Division's analysis with respect to the 11 portfolio securities, 91 were purchases and 57 were redemptions. No commissions were generated by the redemptions and 23 of the purchases. Thus, no commission was available to Adviser in about 54 percent of those transactions. We note that in fiscal 1970, when the turnover rate was 200.1 percent, the concessions amounted to only $94,685.

$18,984 would have been payable by Fund, and a concession of 1.5 percent or $12,656 would have been payable to Adviser. Following redemptions in the amount of $333,600 (at the rate of $11.12 per share compared to the prior purchase prices of $10.95 and $10.98 per share), Fund effected a purchase four months later at $7.66 per share for a total of $229,800, which brought it above the 1 percent breakpoint (to $1,073,550). The sales load and Adviser's concession were accordingly each reduced to $10,735.50.[21]

The Division points out that three months after the repurchases of Rosenthal Fund shares, and two months after the expiration of the period of the letter of intent, Fund redeemed the 21,000 shares of that fund remaining in its portfolio. We note, however, that the net asset value of that fund's shares had declined to about $6.50 per share and that such redemptions were consistent with the exercise of business judgment and did not necessarily indicate that the purpose of the prior transactions was to generate commissions for Adviser.

The record shows, as asserted by applicants, that a substantial amount of Adviser's commissions resulted from the investment of net capital received from the sale of Fund's shares to the public in 1969.[22] Applicants further assert that substantially all the redemptions of the shares of the 11 selected portfolio funds were effected as a defensive measure in three periods in 1969 when the stock market was particularly unstable. Applicants note that in 1969 the Dow Jones Industrial average declined from 953 to 903 between February 13 and March 6 and from 965 to 815 between May 15 and July 31 and fluctuated between 830 and 803 from September 25 to October 16. They state that each successive decline in the market confirmed their fears that the market had not yet bottomed out and that Fund's management, like many other portfolio managers, liquidated "perilous" investments to preserve Fund's assets in liquid form (cash and cash equivalents) or to reinvest the proceeds in funds deemed safer.

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[21] We recognize, as previously indicated, that to the extent Adviser's concession on the Rosenthal and Boston purchases prior to the redemptions exceeded 1 percent of the purchase price, and assuming no further purchases during the period of the letter of intent, Section 17(e) (2) would have required Adviser to return the excess to the principal underwriter. On this record, however, it is doubtful that applicants were aware of such requirement. It should also be noted, with respect to the sales load, that Adviser would under certain circumstances have a fiduciary duty to effect the additional purchase necessary to qualify Fund for the minimum sales load and the resulting savings in sales charges to Fund. See *Russell L. Irish*, Securities Exchange Act Release No. 7687, p. 7 (August 27, 1965), *aff'd* 367 F.2d 637 (C.A. 9, 1966), *cert. denied* 386 U.S. 911.

[22] For the year ended November 30, 1969, Fund issued 1,718,063 shares for $19,450,338. Assuming two-thirds of all the proceeds were invested in load funds, the concessions to Adviser, at the average rate of .8 percent which it received in transactions in such funds, would have amounted to approximately $104,000.

Fund's liquidity ratio or proportion of liquid assets to net assets during the first two periods of substantial market decline in 1969 indicates that many of its redemptions were motivated, at least in part, by its desire to take a defensive position.[23] The ratio, which was less than 3 percent at the beginning of the year, rose to about 58 percent by the end of February and to more than 75 percent by the end of March and from less than 5 percent at the end of May to about 33 percent at the end of June. A significant portion of Fund's high turnover rate in 1969 can be attributed to these high liquidity ratios since, under the turnover rate formula, the divisor (monthly average value of portfolio securities) would be smaller to the extent a proportion of the proceeds of the redemptions was not immediately reinvested in portfolio securities. Although the Division argues that there was little justification for Fund to go defensive since the portfolio funds would also follow that course, we cannot presume that Fund's business judgment was improper. Nor was any evidence offered by the Division to support its assertion that shifts from one diversified portfolio to another afforded little benefit to Fund's shareholders. The fact that funds have diversified holdings does not mean that their holdings or investment results are the same. Changes in the net asset values of the funds in conjunction with other factors such as the quality and policies of their particular managements may impel a business decision to switch to a particular fund notwithstanding that it may have substantially similar basic investment objectives.

Without expressing any opinion on the actual merits of the business judgment exercised in effecting the transactions in the 11 funds analyzed by the Division, we conclude in light of the above factors that the 1969 turnover rate reported by Fund is not sufficient of itself to establish a breach by Adviser of its fiduciary duty to Fund. Accordingly, Adviser is entitled to receive and retain the commissions up to 1 percent except in those instances where, as discussed above, they exceeded the 1 percent limitation in breach of Adviser's fiduciary duty.

OTHER MATTERS

The NASD contends that we have no power to issue the declaratory order requested by applicants because, apart from the matters raised in our order for hearing, the requested order relates solely to Rule 26 as to which there is no actual controversy or uncertainty in these proceedings. We do not

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[23] No information with respect to Fund's liquidity was available for July or October.

agree that, merely because the application requested a declaratory order in terms of Rule 26, we are limited to a consideration of that Rule. This is particularly true when, as evidenced by our order for hearing, the record, and applicants' own briefs and previous correspondence with our staff, various provisions of the Act are relevant to a settlement of the controversy with respect to the commissions held in escrow and future commissions paid to Adviser.

We also reject the NASD's contention that we should exercise our discretion to refuse to issue a declaratory order covering the matters raised in our order for hearing on the grounds that the provisions for such orders in the Administrative Procedure Act (5 U.S.C. 554(e)) does not apply to "a matter subject to a subsequent trial of the law and facts de novo in a court," and that the declaratory order device is intended to inform persons whether or not certain proposed conduct is lawful, whereas applicants have already engaged in conduct deemed objectionable by the Division. Our order herein will be completely effective without the necessity for judicial retrial or decision, and the commissions in question have been and continue to be deposited in escrow. Nor do we find any substance to objections by Adviser that it was entitled to receive a "responsive" pleading by the Division and that we, on the basis of an allegedly improper *ex parte* communication from the staff, raised issues in our order for hearing not posed by the application.[24]

CONCLUSION

On the basis of the foregoing, we will enter an order declaring that Adviser acted as broker for Fund and, no excessive trading in Fund's portfolio to generate commissions having been shown, is entitled under the terms of Section 17(e)(2) of the Act to receive and retain commissions (limited to 1 percent of the purchase price except where a breach of fiduciary duty otherwise appears) paid and to be paid by the principal underwriters of selling funds on purchases from them of mutual fund shares for Fund.

An appropriate order will issue.

By the Commission (Chairman CASEY and Commissioners OWENS, NEEDHAM and HERLONG), Commissioner LOOMIS not participating.

[24] *R. A. Holman & Co.* v. *S.E.C.*, 366 F.2d 446, 455 (C.A. 2, 1967), *amended on reh'g* 377 F.2d 665 (1967), *cert. denied* 389 U.S. 991.