

May 12, 1972

To Our Clients

Use of Brokerage by Investment Managers

In a very significant release the SEC on May 9, 1972 clarified its position with respect to the use of brokerage to compensate for research and other services. The basic SEC position is summed up: "While the duty to obtain the best security price remains, in selecting a broker to secure such price an adviser is not required to seek the service which carries the lowest cost so long as the difference in cost is reasonably justified by the quality of the service offered."

Where the investment manager and the broker are not affiliated the lowest possible brokerage commission does not have to be sought or negotiated if the differential is reasonable in relation to the services provided by the broker. Where the relationship and transaction are bona fide there is a presumption of reasonableness.

Where the investment manager and the broker are affiliated there is no presumption of reasonableness. The following standards apply:

- (1) the commission must be the same as that charged unaffiliated customers in similar transactions;
- (2) the commission must be no higher than the "posted" rates of other qualified brokers for similar transactions (competitive bidding is not required);

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(3) the investment manager must be sure that the affiliated broker is able to get at least as favorable an execution price as another broker; and

(4) since the investment manager already is obligated to provide research, research may not be considered in determining reasonableness.

While these standards are strict, they provide a clear sanction for institutionally affiliated brokers and further negate the conflict arguments advanced in support of exclusion of such brokers from exchange membership.

The SEC concluded: "In short, the Commission seeks clearly to establish that commission costs should be considered as payment for a professional service and should no longer be treated as a special kind of currency which can be used to pay for extraneous services. Instead, the Commission believes that investment managers must assign executions and pay for brokerage services in accordance with the reliability and quality of those services and their value and expected contribution to the performance of the account they are managing."

This seems to bolster our previous advice as to the termination of sales reciprocal business by mutual funds.

Investment Company Advertising

The SEC has now made effective the previously proposed rules permitting:

(1) general descriptions of investment companies in tombstones (Rule 134);

(2) combination of general advertising and investment company tombstones (Rule 134);

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- (3) generic advertising (Rule 135A); and
- (4) summary prospectuses for investment companies (Rule 434A).

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