Sullivan & Worcester
Boston, Massachusetts

April 1, 1968

Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Re: Comments on Proposed Rule 10b-10

Dear Sirs:

We will, in these comments, confine our analysis to the wisdom of adopting the proposed Rule and will not attempt to comment on its technical aspects, its stated premise or the power of the Commission to adopt it. We will, however, comment on the manner in which it has been published.

1. Exchange Act Release No. 8239, proposing Rule 10b-10 states that the proposed Rule is bottomed on the premise that use of give-ups from fund portfolio brokerage commissions to benefit fund managers or distributors violates applicable antifraud provisions of the Exchange Act and the Investment Advisers Act as well as Section 17(e)(1) of the Investment Company Act and may also involve a violation of Section 15(a)(1) of the Investment Company Act. The practice thus condemned, through the apparent adoption of this premise by the Commission, is virtually as old as the investment company industry itself and has been almost universally engaged in openly, with complete disclosure and without previous official challenge. Under these circumstances we suggest that the practice, if it is to be labeled fraudulent or an abuse of trust, should be so labeled only as a result of judicial or administrative proceedings rather than in a release relating to a Rule which would make the practice illegal in the future but, presumably, does not purport to govern past practices. This would have the beneficial effect of judicially testing the announced premise on which the proposed Rule is based. The confusion as to the past practice and its legality under the various securities laws resulting from this release is bound to injure the industry and. those connected, with it. Further, as the Commission has been aware of the practice since it began and has even been regulating the prospectus disclosures that have been made about it, the situation must be even more confusing to the public, which has been abruptly told, in effect, that the practice has been illegal all along. Accordingly, some clarification in a future release would be most helpful.

2. We suggest that the proposed Rule is based upon insufficient economic Investigation and analysis of the investment company industry and its needs. If give-ups are available, as they currently are, the market place has at least indicated that it is necessary to use them to reward dealers for fund share sales and investment ideas and information. Give-ups are a direct financial reward for these two functions which apparently have to be performed by the brokerage community for any management and distribution company if it is to be successful in the usual way. Also, since distribution operations are frequently carried on at a loss, the inability to use give-ups might in some instances force distributors to go out of business or leave their efforts so ineffectual as to put a fund in a self-liquidating situation. Even a large fund cannot long permit redemptions to exceed sales without injury to its shareholders.

Further, the power to direct give-ups has historically been one of the tools manager-distributors have believed were available for the successful conduct of their functions. If this power is made unavailable, it could affect the entire fee structure of the industry, since an important source of financial rewards for the brokers who aid the successful manager-distributor will be eliminated. We suggest that there has not been adequate Investigation whether the services for which give-ups are directed are an integral part of the economic fabric of the Investment company industry. If they are such, it must then follow that eliminating give-ups will create a profit "squeeze" in the Industry since the services will have to be otherwise rewarded.

If such a "squeeze" occurs, it seems certain that only the larger, already successful, businesses will survive and it will become even more difficult for small or new fund managers to establish themselves. It is well-known that funds of less than $25,000,000 are rarely profitable for their managers, and some even larger funds are unprofitable. Thus, a result of the proposed rule may well be that all future fund business will be concentrated in (i) a few giants or (ii) in funds that are managed and distributed by established broker-dealer stock exchange members who are capable of executing portfolio transactions for their funds and can use the profits from their commissions to purchase investment Ideas and information and to support share sales in other ways. The latter assumption is based on the supposition that, at least at present, there is not contemplated any proposal to prohibit such broker-dealers from actually executing the transactions and keeping the commissions. We suggest that such a concentration of fund business would not be in the public interest.

We believe that much more should be determined about the possibly far-reaching and injurious effects of eliminating give-ups before the proposed Rule or anything like it is adopted.

3. Related to this question is, of course, the quantity discount proposed by the New York Stock Exchange, which is apparently based on the assumption that since brokers are willing to give up on large orders, their commissions are higher than they need to be. The quantity discount might eliminate entirely the availability of give-ups in any real economic sense, although presumably the Exchange does not propose this. Again, we suggest that it is not clear that the public would benefit. Unless it is manifest that the services which are rewarded, by give-ups are either (i) unnecessary, or (ii) if not unnecessary, will be performed without reward, the elimination of give-ups (whether effected by the proposed Rule 10b-10 or by quantity discounts), cannot be said to be clearly desirable. We believe that neither of the foregoing has been established, and that the elimination of the means for rewarding what may well be two basic necessities for the success of the fund industry without a thorough investigation of the part which they play and the economic effect of such action would be a dangerous step to take and one which could lead to less desirable alternatives, such as the raising of advisory fees and sales loads to provide revenues to pay for these services.

4. We will not attempt to comment here on the question of whether the present exchange rules permit the type of rebates via reduction of advisory fees which it has been suggested might be required where fund, managers are themselves capable of receiving give-ups or the question whether such reductions in advisory fees might themselves involve a violation of Section 15(a)(1) of the Investment Company Act by creating an uncertainty in the amount of the fee. We believe that all or most exchange rules currently prohibit give-ups directly back to the customer, and it seems to us a mere evasion of such rules for a manager to reduce his advisory fee in the amount of such give-ups received by the manager. We assure that any suggestion that there is official sanction for deliberate evasion of the present rules will not be countenanced. We further assume that a thoroughgoing revision of all exchange rules and appropriate exemptions from Section 15(a)(1) of the Investment Company Act would be part and parcel of the adoption of any rule such as the proposed Rule 10b-10.

Very truly yours,

Sullivan & Worcester