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Muni-Funds: Exempt-Interest Dividends and the Feasibility of Underwriting Fee Recapture

NOTES

MUNI-FUNDS: EXEMPT-INTEREST DIVIDENDS AND THE FEASIBILITY OF UNDERWRITING FEE RECAPTURE

Section 2137 of the Tax Reform Act of 1976[1] enables certain investment companies to distribute as "exempt-interest dividends" the interest received on tax exempt bonds.[2] The provision permits the creation of incorporated mutual funds[3] capable of "passing through" the tax exempt interest received on municipal bonds and other government securities.[4] Prior to section 2137's adoption, closed-end unit investment trusts[5] and municipal bond limited

1. Public L. No. 94-455, § 2137, 90 Stat. 1930 (1976). Section 2137 is codified at I.R.C. §§ 103(f), 265, 852.

2. Section 2137(c) of the Tax Reform Act of 1976, I.R.C. § 852(b)(5), provides in pertinent part: "If, at the close of each quarter of its taxable year, at least 50 percent of the value . . . of the total assets of the regulated investment company consists of [state and local government] obligations . . . such company shall be qualified to pay exempt-interest dividends . . . to its shareholders." The section provides further that an exempt-interest dividend "shall be treated by shareholders . . . as an item of interest excludable from gross income." *Id.* § 852(b)(5)(B).

3. Mutual funds, a type of investment company, consist of pooled liquid assets controlled by an external advisor, which, in return for selecting and managing the investments, receives a fee. The discussion in this Note will be limited to an examination of the most common fund, the diversified, open-end investment company. A diversified, open-end company is one that "invest[s] in the securities of many different issuers" and that "issue[s] 'redeemable' securities [such as] securities whose holders have a right to obtain from the company their proportionate share of the compan[y']s net assets or the cash equivalent." HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, REPORT OF SEC ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. No. 2337, 89th Cong., 2d Sess. 8 (1966) [hereinafter cited as PPI].

4. With certain exceptions, the Internal Revenue Code excludes from gross income interest on "the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia." I.R.C. § 103(a)(1). Regulated investment companies theoretically are taxed to place "investment company shareholders essentially in the same position as if they owned directly the securities held by the fund." *Taxation of Interest on Debt Obligations Issued by State and Local Governments and on Witholding Federal Income Tax on Interest and Dividend Income, Hearings Before the Senate Comm. on Finance,* 94th Cong., 2d Sess. 118 (1976) [hereinafter cited as *Hearings on Bond Interest Taxation*].

5. "Unit investment trusts sell redeemable interests in fixed portfolios of specified securities." PPI, *supra* note 3, at 7. Close-end unit investment trusts, which first appeared in 1961, may pass through tax exempt interest to investors provided the portfolio remains fixed. I.R.C. § 852(d). From their advent, managed municipal bond funds, or "muni-funds," have been competing vigorously with unit investment trusts. Phalon, *Tax-Free Mutual Funds vs. Unit Trusts,* N.Y. Times, Aug. 13, 1977, at 27, col. 1. Phalon notes that in 1977 the marketability of managed funds was slightly better than the marketability of unit trusts. Nevertheless, the

partnerships[6] were the only investment entities similar to mutual funds capable of passing through tax exempt interest. Despite the attractiveness of this exclusive feature, the general public, however, did not use these investment vehicles extensively because following the initial purchase of bonds, neither entity managed the portfolio. By contrast, municipal bond mutual funds, "muni-funds," which provide post-purchase management, received an enthusiastic public response. Within a month after the adoption of the Tax Reform Act, eleven muni-funds were formed,[7] and by July, 1977, $1.5 billion had been invested in the new bond funds.[8]

One factor prompting the enactment of the pass-through provision was the financial difficulties experienced by equity mutual funds in recent years, precipitated by "[perhaps] one of the biggest mass withdrawals from equity securities since the Great Crash of '29."[9] After a spectacular growth, the popularity of mutual funds peaked in 1968, and then slipped for a few years before peaking again in 1972.[10] In 1974, however, the funds lost more than one-

two top competitors produced yields of 5.1% (managed funds) and 6.1% (unit trusts); the management fee charged by the incorporated mutual fund accounted for most of the difference in yield.

6. A 1966 revenue ruling permitted short-lived limited partnerships to invest in municipal bonds and to pass through the tax exempt interest to their partners. Rev. Rul. 66-187, 1966-2 C.B. 246. The limited partnership, however, is not a particularly covenient means of investment; only two were formed before September, 1976, when "muni-funds" were first organized. Sloane, *Personal Finance,* N.Y. Times, Sept. 24, 1976, at 26, col. 5. While testifying on a related matter, a spokesman for the Investment Company Institute, the national association of the mutual fund industry, stated that the use of limited partnerships to convey tax exempt interest was "awkward and difficult." *Hearings on Bond Interest Taxation, supra* note 4, at 112.

7. Phalon, *Mutual Funds Confront the Great Drain,* N.Y. Times, Nov. 7, 1976, § 3, at 7, col. 2. According to a listing by the Investment Company Institute (ICI), 11 funds were operating by December 20, 1976 and 18 other funds had applied for registration with the Securities and Exchange Commission. Letter from the ICI to Financial Editors (Dec. 22, 1976). By July, 1977, 28 funds existed, and an additional 17 were in registration proceedings. BUS. WEEK, July 25, 1977, at 127, 132.

8. BUS. WEEK, July 25, 1977, at 127, 132.

9. Phalon, *Mutual Funds Confront the Great Drain,* N.Y. Times, Nov. 7, 1976, § 3, at 1, col. 1. In a year-end story on mutual funds, *Business Week* noted that "the industry's hopes in 1977 ride on the new tax-exempt bond" but that "most [fund managers] glumly concede that even a strong showing in 1977 will not stop the industry's continuing contraction." BUS. WEEK, Dec. 27, 1976, at 128, 130. During the first eleven months of 1976, the mutual fund industry experienced 14 consolidations or liquidations. *Id.* at 128.

10. The net assets of mutual funds reached $52.7 billion in 1968 before falling in 1969 and 1970 to $48.3 and $47.6 billion, respectively. Resuming an upward trend in 1971, the net assets reached a new high of $59.8 billion in 1972. ICI, 1976 MUTUAL FUND FACT BOOK 7.

quarter of the net assets they had held a year earlier and thereafter have enjoyed only sluggish popularity.[11]

This severe setback of mutual funds cannot be explained entirely by the nation's economic recession in the mid-1970's and its concomitant equity drain. Their troubles also indicate that investors are "skeptical of the 'professional management' that the mutual funds have tried to provide at fees that run into hundreds of millions of dollars a year."[12] Whatever the source of these problems, the difficulties of this powerful financial sector clearly motivated, in part, the adoption of the pass-through provision.

Section 2137, then, was enacted to promote investment in mutual funds, but the legislative history of its passage discloses Congress' failure to consider several problems associated with the development of municipal bond mutual funds.[13] The rapid growth experi-

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11. The net assets of mutual funds, which had dropped to $46.5 billion in 1973, fell further in 1974 to $34.1 billion. These figures exclude the assets of those "money market" funds that deal in such short-term securities as Treasury bills, bank certificates of deposit, and commercial paper, and include those that manage conventional securities. *Id.* The total assets of conventional funds at the end of 1976 equalled $47.5 billion, a $5.3 billion increase from the previous year. According to the ICI, this result reflected both the "net cash flow of money into bond funds and the increase in assets of equity-oriented funds" caused by the general rise in stock prices. ICI, 1977 MUTUAL FUND FACT BOOK 4.

The value of annual distributions to shareholders of net realized long-term capital gains and income dividends provides an index of mutual fund performance reflecting more variables than does the net asset index. In the late 1960's, capital gains distributions exceeded those of investment income; in the preceding 10 years, both types of distributions had been roughly equivalent. In 1970, however, capital gains distributions shrank from $2.5 billion to $922.1 million; by 1971 they decreased to $775.5 million, an amount slightly more than one-half the total investment income distributions. After a period of growth in 1972-1973, capital gains distributions sank in 1974 to $484.3 million and in 1975 to $219.2 million. These distributions then increased in 1976 to $470.9 million.

Net investment income represents the distributions and interest on a fund's portfolio, less its operating expenses; capital gains distributions, however, are indicative of long-term profits realized by the fund on its sale of portfolio securities. *Id.* at 14.

As a result of the preceding years' setbacks, in 1976, shareholder accounts in conventional funds dropped to pre-1968 levels. Another revealing figure in 1976 was the 15.2% rate of redemption of average net assets, representing the highest figure ever obtained and exceeding the 1975 rate by 5.5%. *Id.* at 20.

12. Phalon, *supra* note 9, at 1, col. 3.

13. The initial House bill, which later became the Tax Reform Act of 1976, contained no section similar to § 2137. The ICI urged both the Senate Finance Committee and the House Ways and Means Committee to permit mutual funds to pass through tax exempt interest. Although the possibility of reform of the tax exempt system was under consideration, the ICI suggested that the amendment be adopted "whether or not the Internal Revenue Code is amended to permit state and local governments at their option to issue taxable bonds since large amounts of existing tax-exempt bonds would remain outstanding and many issuers might well elect to offer new bonds on a tax-exempt basis." *Tax Reform Act of 1975: Hearings*

enced by the muni-funds warrants a more careful analysis of these problems. This Note will examine two major problems associated with the operation of muni-funds: their effect on the equity and cost-efficiency of the federal tax system, and the duty to offset underwriting fees against advisors' commissions. Consideration also will be given to the necessity for regulatory changes if muni-funds are expected to recapture underwriting fees.

THE EFFECT OF THE OPERATION OF MUNI-FUNDS ON THE FEDERAL TAX SYSTEM

Since the adoption of the sixteenth amendment[14] and the enactment of the first income tax laws exempting municipal bond interest from taxation,[15] "the Treasury Department has, more or less continuously been seeking to eliminate the tax exemption on municipal bonds."[16] This exemption has been criticized[17] because it not

on H.R. 10612 Before the Comm. on Finance of the Senate, 94th Cong., 2d Sess. 3575 (1976) [hereinafter cited as *1975 Hearings*] (supplemental memorandum on behalf of the ICI).

In May, 1976, the chairman of the Securities and Exchange Commission, Roderick M. Hills, announced his support for the measure. While emphasizing that his views did not necessarily reflect those of the Commission, Hills stated that "[the Commission] supports the ICI on the proposal." ICI, MUTUAL FUNDS FORUM 17 (June 1976).

Though neither the House bill nor the version reported by the Senate Finance Committee included the ICI proposal, it was introduced as an amendment on the Senate floor. Sen. Amend. 2035, 122 CONG. REC. S13714 (daily ed. Aug. 6, 1976). During the abbreviated debate, Senator Percy informed his colleagues that the Treasury Department did not object to the proposal, *id.* at S13715; the amendment was added by a voice vote. *Id.*

Earlier, the Senate Finance Committee had proposed an amendment similar to that ultimately enacted in 1976, § 42 of the Technical Amendments Act of 1958. The proposal won approval in the Senate but failed in the Conference Committee. S. REP. No. 1983, 85th Cong., 2d Sess. 61-63, *reprinted in* [1958] U.S. CODE CONG. & AD. NEWS 4850-52. In the Senate Finance Committee Report, Senator Paul Douglas criticized the provision: "Until such time as a broad approach to the solution to these problems [of the propriety of the exemption] can be provided, it is unwise further to entrench in the Federal tax law the existing preferential treatment." *Id.* at 264, *reprinted in* [1958] U.S. CODE CONG. & AD. NEWS 5051. The conferees described the amendment and noted that the "Senate recedes." CONF. REP. No. 2632, 85th Cong., 2d Sess. 30, *reprinted in* [1958] U.S. CODE CONG. & AD. NEWS 5066.

14. The Sixteenth Amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI.

15. Revenue Act of 1913, ch. 16, § IIB, 38 Stat. 168. The current code exempts municipal bond interest under I.R.C. § 103.

16. Morris, *Tax Exemption for State and Local Bonds,* 42 GEO. WASH. L. REV. 526, 526 (1974). *See also* J. MAXWELL, FINANCING STATE AND LOCAL GOVERNMENTS 190 (1965).

17. *See generally* Fortune, *Tax Exemption: Issues and Alternatives,* 1973 NEW ENGLAND ECON. REV. 17; Gardner, *Tax Immune Bond,* 8 GEO. WASH. L. REV. 1200 (1940); Gelfand, *Tax Exempt Securities and the Doctrine of Reciprocal Immunity,* 32 TEMP. L.Q. 173 (1959);

only primarily benefits individuals in high income tax brackets but also is cost inefficient. The impact of the operation of muni-funds on the efficiency and equity of the federal tax system, though, is unclear. Undoubtedly, section 2137 will affect pre-existing investment patterns, but its repercussions may not be those anticipated by its sponsors.

The Equity Problem

Traditionally, institutions such as commercial banks and fire and casualty insurance companies have made large investments in the municipal bond market.[18] In contrast, the household sector, although growing in importance, has accounted only for approximately one-third of the municipal bonds purchased.[19] Individuals have been discouraged from investing directly in tax exempt bonds primarily because the denominations in which most bonds are issued require investors to purchase at least $5,000 of securities.[20] Moreover, substantial knowledge of the bond market and inclusion in a relatively high income tax bracket are practically prerequisites to direct investment.[21] Consequently, wealthy persons comprise the principal individual purchasers of municipal bonds.[22]

Morris, *Exemptions For State and Local Bonds,* 42 GEO. WASH. L. REV. 526 (1974); Mortori & Bliss, *Taxation of municipal Bond Interest—"Interesting Speculation" and One Step Forward,* 44 NOTRE DAME LAW. 191 (1968); Ratchford, *Revenue Bonds and Tax Immunity,* 7 NAT'L TAX J. 40 (1954); Note, *The Continuing Debate Over the Municipal Bond Exemption: Time For a New Approach By Reformists,* 25 SYRACUSE L. REV. 953 (1974) [hereinafter cited as *Continuing Debate*].

For recent discussions of the exemption's effectiveness as an indirect subsidy of local borrowing costs, see J. PETERSON, JOINT ECONOMIC COMMITTEE OF CONGRESS, 94TH CONG., 2D SESS., CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT 55-58 (Joint Comm. Print 1976) [hereinafter cited as CHANGING CONDITIONS]; STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 94TH CONG., 2D SESS., TAXABLE BOND ALTERNATIVES FOR STATE AND LOCAL GOVERNMENTS 1-9 (Comm. Print 1976) [hereinafter cited as TAXABLE BOND ALTERNATIVES].

18. CHANGING CONDITIONS, *supra* note 17, at 35.

19. *Id.* From 1974-1975, however, individual investors purchased 60% of the net new supply of municipal bonds. *Id.*

20. 122 CONG. REC. S13715 (daily ed. Aug. 6, 1976) (remarks of Sen. Percy).

21. *See* text accompanying note 28 *infra.*

22. "The average marginal tax rate for municipal bond owners has recently been estimated to be approximately 55 percent. . . . [A]bout 70 percent of municipal bonds held by households are owned by units with incomes of $50,000 or more." CHANGING CONDITIONS, *supra* note 17, at 39 (footnote omitted). According to data compiled by the Investment Company Institute, before the end of 1976, the average shareholder's muni-funds account amounted to $12,000. ICI, News Release 2 (May 3, 1977).

Muni-funds were designed specifically to ameliorate the burdens upon individuals entering the tax exempt bond market.[23] To date, though, muni-funds have been only mildly successful in eroding these barriers. Admittedly, the minimum muni-funds investment, which ranges from $1,000 to $5,000, has been substantially reduced.[24] Furthermore, by providing for the management of the funds' assets, muni-funds have reduced the amount of prior knowledge necessary to invest in the bond market. Nevertheless, the major barrier to private purchase of municipal bonds, inclusion in a relatively high tax bracket,[25] remains. Unless an individual maintains a sufficiently high personal income, he will be unable to benefit from a municipal bond investment not only because these bonds have lower initial yields than corporate issues,[26] but also because the rate of return on an investment in a muni-fund is diminished even further through the assessment of management fees.[27] At the current rates of return on bonds, an individual must be in the twenty-eight percent marginal tax bracket before a direct individual investment in municipal bonds would be more profitable than a comparable purchase of corporate bonds.[28]

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23. When introducing the amendment that would become § 2137, Senator Percy stated: "it is effectively impossible for investors with limited resources and experience to engage in trading in these securities. This amendment allows small investors to invest in tax-free bonds with less individual risk and lower capital requirements, by sharing in a fund with a diversified portfolio under professional management." 122 CONG. REC. S13714 (daily ed. Aug. 6, 1976). The ICI presented similar arguments before the Senate Finance Comittee. *1975 Hearings, supra* note 13, at 3575.

24. Phalon, *Personal Finance: New Tax Laws Spawning Municipal Bond Funds,* N.Y. Times, Oct. 20, 1976, at 69, col. 2. Unit investment trusts also required minimum investments of $1,000 to $5,000 in the fall of 1976. Phalon, *Personal Finance,* N.Y. Times, Sept. 25, 1976, at 26, col.4.

25. *See* note 22 *supra.*

26. During the week ending March 10, 1978, corporate bonds rated Aa averaged an interest rate of 8.5%, and 20 municipal bonds that had been active on the market averaged 5.58%. BUS. WEEK, March 27, 1978, at 79.

27. Management fees often are set at one-half percent of the fund's total assets. *See* note 57 *infra.*

28. Dreyfus Corp., *Dreyfus Tax Exempt Bond Fund, Inc.* (1976) (brochure tax chart); *see, e.g.,* Merrill Lynch, Pierce, Fenner & Smith, Inc., *How Technical Analysis Can Help You* (June, 1978).

For example, an investor in the seventy percent tax bracket who purchases a $1,000 municipal bond yielding six percent, rather than a corporate bond yielding eight percent, would receive a tax benefit of thirty-six dollars. Although the corporate bond would yield interest of eighty dollars, fifty-six dollars would be paid in taxes, leaving income of twenty-four dollars. The municipal bond would yield sixty dollars of nontaxable interest. By contrast, an individual in the thirty percent tax bracket who made the same investment decision would

Clearly, the mere influx of individual investment in the municipal bond market alone will not correct the inequitable distribution of the tax benefits created by the municipal bond interest exemption. Inherent in the structure of the exemption are the disproportionately greater benefits to those persons in high income tax brackets, a phenomenom that will continue regardless of the number of new investors attracted to the municipal bond market by the existence of muni-funds.

The Cost-Efficiency Problem

Municipal bond purchasers generally realize a net tax savings on their investments, despite the securities' lower interest rates. This effect is the consequence of a system that inefficiently promotes investment in debt obligations of state and local government: the federal government loses more tax revenue because of the interest exemption than state and local governments save from issuing low interest tax exempt bonds. The magnitude of the problem of money loss, or leakage, appears in a report by the Joint Economic Committtee of Congress, which states that "in fiscal 1976, of the approximately $4.8 billion in foregone Treasury receipts [resulting from the municipal bond interest exemption], $3.5 billion was passed to State and local borrowers in reduced interest costs and $1.3 billion was retained by investors."[29]

If muni-funds attract permanent new investors into the bond market, the expanded sales probably will cause an increase in the overall amount of leakage, but the loss per unit of borrowed money will decline. An increased demand created by muni-funds could be expected to prompt an expansion in the size and number of municipal offerings,[30] which in turn would promote a proportionate in-

receive only a four dollar tax benefit. The latter investor would receive interest of eighty dollars and sixty dollars on the corporate and municipal bonds respectively; however, his after-tax income from the corporate investment, on which he would have to pay taxes of twenty-four dollars, would be fifty-six dollars.

29. CHANGING CONDITIONS, *supra* note 17, at 56. In analyzing assumptions made in estimating foregone revenues and reduced borrowing costs, the report states that "the subsidy is more efficient than it appears." *Id.* at 57. The ratio of foregone revenues to interest costs saved may reflect inaccurately the true relationship between these figures. Factors unique to municipal bonds cause their rates to be higher than otherwise would be necessary to attract investors seeking tax exempt income. In addition, if taxable municipal bonds replace tax exempt bonds, other tax shelters then would become more competitive, which would cause interest rates to rise. *Id.* at 56-57.

30. In recent years, state and local governments, relying more on borrowed funds, have

crease in the number of bonds from which leakage occurs. If the new muni-funds investors are in the lower tax brackets, however, less leakage per unit would occur because the net tax savings from municipal bond investments decrease as a function of the individual's tax bracket.[31]

The Effect of Section 2137 on Pending Reforms of the Municipal Bond Interest Exemption

Not only may section 2137 fail to improve the equity and cost-efficiency of the federal tax system, it also may delay or prevent the adoption of major reforms designed to alleviate problems inherent in the present treatment of municipal bond interest.[32] Before the adoption of section 2137, Congress had been encouraged to consider the enactment of a taxable bond option[33] that would enable munici-

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increased their total indebtedness from $71 billion in 1960 to $207 billion in 1974. CHANGING CONDITIONS, *supra* note 17, at 4. By January 1, 1977, the operation of muni-funds apparently accelerated this trend. Perhaps anticipating the demand muni-funds would create, states and localities offered a substantial number of new issues. In one week $625 million of municipal obligations were to be sold. *Prices Skid Further Amid Rising Anxiety Over Effect of Democrats' Spending Plan,* Wall St. J., Jan. 7, 1977, at 14, col. 2. The resulting superabundance of municipal bonds contributed to "one of the severest market declines in recent years" in the general bond market. *Id.* Before the end of 1977 a record $44.9 billion of new municipal bond issues were offered for sale. This amount exceeded by 33% the prior record established in 1976. Much of this volume might have included financing to replace old issues. *Finance Trends,* U.S. NEWS & WORLD REP., Jan. 16, 1978, at 68. This initial response by state and local governments indicates that any spurring of demand by muni-funds will be matched by an increase in municipal offerings.

31. *See* text accompanying note 28 *supra.*

32. Attempts have been made to reform, rather than to eliminate, the interest exemption because of the strong argument that elimination would be unconstitutional. In Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895), the Supreme Court held that municipal bond interest was immune from federal taxation, noting that a contrary holding, in effect, would subject state and local governments to taxation by the federal government. *Id.* at 583-86. "[T]he United States [has] no power under the Constitution to tax either instrumentalities or the property of a State." *Id.* at 586.

One commentator recently suggested that the Court had "ostensib[ly] limit[ed] . . . immunity to those devices which sustain government functions that are essential to the existence of the state and local government." *Continuing Debate, supra* note 17, at 957-58 (footnote omitted). According to the author, if the federal government could offset any loss "in revenue from bond sales resulting from elimination of the exemption," the bond interest exemption could be eliminated constitutionally. *Id.* at 958.

33. For a review of taxable bond proposals introduced through 1973, see *Continuing Debate, supra* note 17, at 958 n. 27. In 1976, three congressional bills proposed a taxable bond option. Two bills would have established a 40% federal interest subsidy for taxable municipal bonds, *see* S.2800, 94th Cong., 2d Sess. (1976); H.R. 11214, 94th Cong., 2d Sess. (1976), and one would have allowed a 35% subsidy. *See* H.R. 12774, 94th Cong., 2d Sess. (1976). President

pal issuers of taxable bonds to receive federal subsidies covering the higher interest costs associated with those securities. The relative instability of the municipal bond market in the 1970's[34] created doubts among many governmental bodies about the marketability of untaxed municipal bonds. Consequently, the subsidized, or taxable, bond option, which had been opposed previously by those fearful of increased federal control over local financing mechanisms, met less resistance[35] than in the past.[36]

The probablity of passing such a bill, though, has been reduced by the development of muni-funds. The increased demand for municipal bonds stirred by the muni-funds undoubtedly will enhance state and local governments' ability to market tax-free securities. Moreover, because such legislation would reduce the number of exempt-interest bond issues available for purchase, the mutual fund industry would oppose a taxable bond option. The lobbying efforts of this important sector of the financial industry, combined with increased resistance from local governments, could reduce significantly the chances for the adoption of a taxable bond option provision.[37]

Carter submitted a taxable bond option proposal to Congress in January, 1978. *See* [1978] SEC. REG. & L. REP. (B&A) No. 437, at A-7 (Jan. 25, 1978).

34. Several factors caused the instability of the bond market during the 1970's. The most important of these included the sensitivity of commercial banks to periods of tight monetary policy when their need for liquidity increased, the availability of alternative tax shelters, and the unrelated financial losses suffered by fire and casualty insurance companies which coincidentally had invested heavily in municipal bonds. CHANGING CONDITIONS, *supra* note 17, at 36-38.

35. For an example of the municipalities' increased interest in the bond option bills, see *Hearings on Bond Interest Taxation, supra* note 4, at 54 (testimony of J. Peterson, National Governors Conference Center for Policy Research and Analysis).

36. Following a 1973 Treasury Department proposal for a taxable bond option, local and state governments issued statements of opposition, contending that "the Federal Government . . . would use an option to entrap State and local governments and then would withdraw tax exemption, leaving them at the mercy of the direct subsidy program." CHANGING CONDITIONS, *supra* note 17, at 63. In 1975, attention focused on New York City's problems and proposals for direct federal credit assistance. *Id.* at 63-64. By 1976, however, the Treasury Department again proposed the taxable bond option subsidy as a method for minimizing state and local borrowing costs. *Id.* at 64; TAXABLE BOND ALTERNATIVES, *supra* note 17, at 10. Although the proposal is gaining greater acceptance, municipalities still resist taxable bond option bills and probably remain the strongest adversaries to such a change. When testifying on taxable option bills, the Municipal Finance Officers Association (MFOA), a borrower's organization, stated that it would only support legislation that maintained "freedom from Federal controls, . . . savings on interest costs, . . . [and] retention of viable competitive private marketing channels." *Hearings on Bond Interest Taxation, supra* note 4, at 54 (testimony of Andre Blum, MFOA).

37. One observer has suggested, however, that the muni-funds may contribute to the de-

Thus, municipal bond mutual funds are popular and permanent additions to the investment market and must be considered in any new studies concerning the potential reform of the tax treatment accorded municipal bond interest. Given the apparent permanence of muni-funds, their operation poses a problem affecting all mutual funds: whether the fund advisors's fee should be offset with underwriting commissions earned by the advisor's affiliates on new issues sold to the fund. This issue is of particular concern to municipal bonds funds because certain provisions in the laws regulating mutual funds must be amended to provide specific exemptions for muni-funds if, as has been held, the funds have a duty to recoup underwriting commissions. To the extent that muni-funds proceed to offset and thus lower their advisory fees whenever feasible, investors may receive slightly larger returns on their investment. This result would permit persons whose low income tax bracket presently prevents them from investing profitably in tax exempt municipal bonds to enter that market, thus simultaneously decreasing the equity and leakage problems associated with tax exempt securities.

Offsetting Advisory Fees With Recaptured Underwriting Commissions

Any inquiry into whether a fund advisor should offset his fee by recouping or recapturing underwriting commissions must be made within the context of the statutes, the case law, and the regulations generally affecting muni-funds. Such an analysis, therefore, provides an opportunity for examining the legal environment in which these new funds operate. More specifically, the following discussion focuses on four issues: whether offsetting is feasible; whether it is desirable from a policy standpoint; whether the advisor's fiduciary duty requires him to recoup underwriting commissions; and whether, apart from any duty, such recoupment is permitted by the statutes and case law.

mise of tax exempt bonds by informing the public that the municipal bond interest exemption "is the most expensive subsidy we have in our tax system." Belliveau, *The darker side of the muni fund boom*, Institutional Investor, January, 1977, at 138 (presenting the ideas of John Heimann, former New York State Commissioner of Banks). Heimann warned that, if interest rates are lowered, muni-fund growth may encourage state and local officials to enter the bond market even though they might overextend the capacities of their jurisdiction. *Id.* Moreover, Heimann suggested that muni-fund managers would be dissuaded from predicting interest rates and from actively managing portfolios. *Id.*

The Feasibility of Underwriting Commission Recapture

Before the desirability or legal necessity of the offsetting/recapturing procedure can be analyzed, the feasibility of the process must be determined. A mutual fund, consisting of a group of investors who pool their resources, is managed by a professional advisor. The advisor may be a board of trustees, an employee of the fund, or an independent company, but his services usually are more akin to those provided by employees or by a board of directors rather than by a separate entity. Large investment organizations often act as advisors to affiliated funds with diversified investment objectives. Of course, these organizations also conduct operations in other types of investment activities, such as brokerage, dealing, and underwriting. Thus, recouping becomes feasible when a fund advisor is affiliated with an underwriter.

Recouping is possible, though, not only because advisors and underwriters might be affiliated but also because for large purchases funds pay underwriters commissions that typically are higher than necessary to cover costs and yield a reasonable profit. Underwriters earn commissions when they sell at a fixed rate of return stocks or bonds that they have purchased from the issuer at a fixed discount from the price quoted dealers or public customers. For example, the underwriter in the initial syndicate might buy at $99 per share and sell at $99.50 to a dealer in a selected selling group. The dealer in turn receives a "selling concession" when he sells at $99.75 to a retailer-dealer. The customer ultimately buys the stock from the retailer at $100 per share without the benefit of a discount for volume purchasing. Thus, the economies of a large-scale sale to a fund may provide an affiliate of the fund's advisor, who has participated at some stage in this underwriting process, with an excessive commission. In a process described as recapturing the underwriting commission, this excessive amount could be applied to offset the compensation received by the fund's advisor.[38]

The Desirability of Recapture

Several policy issues pertaining to the manner in which underwriting commissions are set are relevant to a discussion of the recap-

38. The adoption of this process was urged by the plaintiffs in Papilsky v. Berndt, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,128 (1976). *See* notes 112-17 *infra* & accompanying text.

ture of commission and offsetting advisory fees. Fixed by private agreement between the issuer and the syndicate,[39] the commissions reflect little sensitivity to the reduced costs made possible by volume sales to entities such as mutual funds;[40] consequently, underwriters often receive more compensation than necessary to cover their costs and yield a reasonable profit.

This situation is similar to the experience with fixed brokerage commissions,[41] which normally included extra compensation then used to pay indirectly the costs of research and the sale of the fund's shares. When fixed brokerage rates were abolished, however, mutual fund managers began seeking new circuitous methods of paying for these services.[42] Increasingly, brokers performing services for funds were compensated through underwriting commissions.[43] Sometimes,

39. 3 L. Loss, Securities Regulation 1615 (1961). Some debate exists over whether the underwriting commissions, or spreads, actually are fixed. An attorney for the Securities and Exchange Commission (SEC) has indicated that the SEC questions whether the underwriter's ability to maintain fixed spreads has been limited by the use of swap arrangements whereby a broker-dealer agrees to buy securities from a customer if the latter will purchase securities that the former is offering for sale. Belliveau, *How institutions are still getting something for nothing*, Institutional Investor, April, 1976, at 32-33. Regarding this practice, the SEC lawyer posed the question: " 'If these swaps [involving payment by the broker-dealer of more than a fair market value for the customer's securities] do exist . . . then aren't brokers essentially giving an institutional buyer a choice between getting a discount on the new issue by doing a swap or paying the offering price and getting research?' " *Id.* at 33. The Belliveau article states that "should the SEC decide the underwriting spreads are *not* fixed, but really quite negotiable, the use of designated orders to pay for research might raise some of the same fiduciary questions as does paying up on listed trades (nor would they be protected by Section 28(E), the amendment to the Securities Act that allows paying up for research)." *Id.* at 32.

In United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953), a New York district court determined that the underwriting agreements of 17 investment banking firms fixed prices; nevertheless, the firms' actions did not violate per se the antitrust laws. *Id.* at 699. According to the court, the syndicate system served "its purpose so well" that the "eggs cannot now be unscrambled." *Id.* at 688. For a review of the SEC's investigation into fixed spreads and resale price maintenance and for a discussion of *Morgan*, see 3 L. Loss, *supra*, at 1615-22.

40. For information concerning the relationship between the costs of underwriting and the volume of sales, see Hunt, Williams, & Donaldson, Basic Business Finance 354 (1974). The underwriting system differs somewhat from the brokerage system in that an underwriter not only performs a marketing service but also undertakes an insurance function. Unlike the costs of marketing, the insurance risk assumed by the underwriting syndicate is relatively insensitive to economies of scale.

41. *See* notes 63-82 *infra* & accompanying text.

42. *See* Belliveau, *supra* note 39, at 29.

43. In a notice to its members, the National Association of Securities Dealers (NASD), pursuant to 15 U.S.C.A. § 78s(b)(2)(B) (Supp. 1977), has proposed changes, designed to halt abuses in the underwriting process related to the use of selling concessions, discounts, and allowances. NASD, Notice to Members 77-31, Sept. 23, 1977. The notice contains a thorough description of the abuses.

through a "designation of orders" scheme, fund managers, upon purchase of large blocks of shares in a new issue, would arrange for the payment of the underwriting commissions to specific brokers either in the syndicate or in the post-underwriting selling group.[44] This designation is easiest, though, when the brokers performing services for a fund coincidentally are members of the selling syndicate. At the request of a fund-customer, an unaffiliated participating broker can be named to a syndicate by the managing underwriter, thereby enabling the broker to receive designated commissions. This practice has led some brokers to form departments solely to facilitate such transactions.[45]

The use of designated orders presents several of the same problems that existed when fund managers used brokerage commissions to pay indirectly for services. For example, a manager's actual costs of transacting purchases for the fund still might remain hidden, thereby facilitating excessive advisory fees.[46] In addition, a fund manager might purchase certain new issues at a time when a stock's purchase price exceeds its true value solely for the purpose of designating orders to pay research debts.[47]

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44. Belliveau, *supra* note 39, at 29. Commissions can be routed to dealers as payment for research through the use of the "bill and deliver" practice, a variation of the designated order. The bill and deliver device involves the purchase of a block of securities by an institution, which then requests that the commissions it pays be credited to several dealers, although the institution is sent only one bill and receives only one security certificate. NASD, Notice to Members 77-31, Sept. 23, 1977, at 14.

45. Belliveau, *supra* note 39, at 30.

46. When the shareholders contribute to the advisor's fee and to separate costs of portfolio management, such as underwriting fees, they actually may be paying twice for some research sevices. The advisor "obligates itself. . . to base its decisions on reasonably valid information and to gather that information;" therefore, its acceptance of the entire management fee when it has used fund-paid underwriting fees to purchase some research arguably is improper. Note, *Conflict of Interest in the Allocation of Mutual Fund Brokerage Business*, 80 YALE L. J. 372, 377 (1970) [hereinafter cited as *Conflict of Interest*]. Advisors argue that management contracts impliedly contemplate the usage of brokerage commissions (and by analogy underwriting fees) for corroborative research. *Id.* The contracts, however, are "rarely the products of arm's length bargaining; whether or not they 'contemplate' corroborative research is largely determined by adviser's fiat." *Id.* This critique, of course, undermines not only the legitimacy of using underwriting fees to pay for research but also the rationale behind statutorily allowing the use of brokerage commissions to pay for research debts when the negotiated rates have not eliminated excessive brokerage compensation completely. *See* 15 U.S.C.A. § 78bb(e)(1) (Supp. 1977); Jordon, *"Paying Up" For Research: A Regulatory and Legislative Analysis*, 1975 DUKE L. J. 1103.

47. Attorneys from both the Securities Exchange Commission and the National Association of Securities Dealers suspect that portfolio managers might be unable to determine objectively whether to purchase a stock after it has been placed on the market or as a new

Even if the cost savings created by the use of designated orders inure to the benefit of the funds rather than their advisors, this method of effecting economies from large volume purchases of new issues is unavailable to noninstitutional buyers. Thus, purchasers who are unable to participate in order designations or similar transactions but who buy securities in large enough blocks to provide the underwriter with some economies of scale have no means to recoup the excessive compensation emanating from fixed underwriting fees.

Without study, an assessment of whether fund shareholders would benefit more from recapture than from some other use of excessive underwriting compensation would be speculative. Arguably, funds should not pursue the uncertain benefits of recapture if such efforts would upset their ability to participate in designated order transactions and would deprive fund shareholders of the benefits flowing from the designated order system. Moreover, an alteration in the present system of underwriting fees fixed by private agreement between an underwriter and an issuer would obviate the need for recapture as well as the current practice of designating orders to recoup excessive underwriting commissions.

Consistent with its opposition to fixed brokerage commissions, the Securities and Exchange Commission (SEC) may question the lack of negotiated underwriting commissions. For example, the SEC was instrumental in persuading the New York Stock Exchange to liberalize volume discounts in its rate structure, a change that contributed to the demise of customer directed give-ups. Moreover, in regard to the recapture of brokerage commissions, proposed rule 10b-10 and rule 19b-2, enacted under the Securities Exchange Act of 1934, reflected this same opposition to rate-fixing; the former would impose on managers a fiduciary duty to undertake recapture for their beneficiaries, and the latter prohibits fund managers from exploiting the system of fee-fixing unless other investors are able to do likewise. Following the abolition of rate-setting, the SEC stated: "The existing commission rate structure had . . . led to distortions, evasions, conflicts of interest and inefficiencies . . . ."[48] It commented that because brokers often were compensated through such devices as give-ups and reciprocity, methods analogous to designated orders, "managers [were] constantly tempted to direct the

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issue (when the price often is higher) if the latter alternative provides a means to fund research debts. Belliveau, *supra* note 39, at 33.

48. Securities Exchange Act Release No. 11203 (Jan. 23, 1975), at 25.

brokerage business of their beneficiaries to brokers who [would] provide services for the benefit of the manager"[49] rather than for the fund.

Unlike commissions paid to brokers, however, those paid to underwriters are established by private contract; thus, perhaps the "public policy questions are not as compelling as they were with the old fixed [brokerage] commissions."[50] In addition, underwriting commissions have remained fixed despite legislative implementations of negotiable brokerage rates, suggesting that the public interest is not contravened so obviously by privately fixed underwriting commissions as by publicly set brokerage rates.

Decisive answers to the policy questions concerning the desirability of underwriting recapture will be unavailable without further study. As previously discussed, this issue, which is enmeshed within the controversy surrounding separately fixed underwriting compensation, could become moot if mutual funds and other large lot buyers were able to negotiate their underwriting fees. Assuming that the practice of fixing underwriting compensation by private agreement between the issuer and the underwriter continues, however, the possibility of attempting recapture or of maintaining the current practices that permit fund advisors to utilize excessive compensation must be considered.

The Fiduciary Duty of Fund Managers to Recapture Underwriting Commissions

Assuming the feasibility and desirability of underwriting fee recapture, the most important nonpolicy question is whether fund managers have a duty to recapture. Resolution of this issue requires an analysis of the statutes governing mutual funds and of the case law developed recently and in the years before implementation of negotiated brokerage commissions.

The Investment Company Act of 1940 (ICA),[51] together with the Investment Company Amendments Act of 1970 (ICAA),[52] principally regulate the mutual fund industry. Following the discovery of practices in the mutual fund industry inimical to investors' inter-

49. *Id.* at 25 n. 42.
50. Belliveau, *supra* note 39, at 32.
51. Ch. 686, 54 Stat. 789 (current version at 15 U.S.C. § 80a (1970)).
52. Pub. L. No. 91-547, 84 Stat. 1413 (amending scattered sections in 15 U.S.C. § 80a (1970)).

ests,[53] the ICA was designed to eliminate "outright dishonesty, managerial self-dealing in securities and other types of property, unsound financial structures and immunity from liability for misconduct."[54] The Senate Committee on Banking and Currency, the ICA's principal drafter, was less concerned with problems of "managerial compensation, underwriting charges, and brokerage commissions, [which] seemed . . . of secondary importance . . . while the study was in progress."[55]

Although the problem of compensation of mutual fund advisors had been noted and studied extensively,[56] not until the passage of the ICAA[57] was management fee-setting made a matter of fiduciary

53. *Report of the SEC On Investment Trusts and Investment Companies* (1938-40). The Report was issued in five parts and numerous supplements, some of which failed to reach Congress until after the passage of the ICA. *See generally* North, *A Brief History of Federal Investment Company Legislation,* 44 NOTRE DAME LAW. 677, 677-79 n. 7 (1969). For a history of the ICA, see Barnard, *Codification and the Investment Company Act of 1940,* 22 BUS. LAW. 850 (1967); Farina, Freeman, & Webster, *The Mutual Fund Industry: A Legal Survey,* 44 NOTRE DAME LAW. 736, 787-808 (1969); North, *supra,* at 680-84; PPI, *supra* note 3, at 63-72.

54. PPI, *supra* note 3, at 9-10.

55. *Id.* at 65.

56. Several major studies were performed between 1958 and 1970. Two were general, SECURITIES AND EXCHANGE COMMISSION, SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pts. 1-4 (1963); WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. Doc. No. 2274 , 87th Cong., 2d Sess. (1962), but a third, PPI, *supra* note 3, comprised an exhaustive examination of many aspects of the mutual fund industry, including the function of management and its cost. The report of the study, which made specific legislative proposals, was followed by meetings "to reach an agreement with respect to controversial areas of legislation, including the fairness of management fees and sales charges." Manges, *The Investment Company Amendments Act of 1970—an Analysis and Appraisal After Two Years,* 14 B.C. INDUS. & COM. L. REV. 387, 390 (1973). The impetus for these studies arose from the observation that investment advisors may determine their fees while subjected to a conflict of interest. For general commentary pertaining to management fees, see Conference on Mutual Funds, *The Mutual Fund Management Fee,* 115 U. PA. L. REV. 726 (1967); Glick, *Mutual Fund Management Fees: In Search of a Standard,* 25 BUS. LAW. 1471 (1970); Note, *Mutual Fund Advisory Fees and the New Standard of Fiduciary Duty—interpreting the 1970 Mutual Fund Act,* 56 CORNELL L. REV. 627 (1971); Note, *Mutual Funds and Their Advisers: Strengthening Disclosure and Shareholder Control,* 83 YALE L. J. 1475 (1974) [hereinafter cited as *Strengthening Disclosure*]; Note, *The Mutual Fund and Its Management Company: An Analysis of Business Incest,* 71 YALE L. J. 137 (1961); Comment, *The Relationship Between the Investment Adviser and the Mutual Fund: Too Close for Comfort,* 45 FORDHAM L. REV. 183 (1976). For commentary on the possibility of the recapture of brokers' fees, see Miller & Carlson, *Recapture of Brokerage Commissions by Mutual Funds,* 46 N.Y.U.L. REV. 35 (1971); Comment, *Mutual Funds and Independent Directors: Can Moses Lead to Better Business Judgment?,* 1972 DUKE L. J. 429. One commentator has argued that fund advisors should not be forced to recapture; rather, brokers should be prevented from executing orders for funds whose shares they sell. *See Conflict of Interest, supra* note 46, at 392.

57. Concern over the manner in which advisory fees are calculated arose primarily because

responsibility.[58] Imposition of this fiduciary duty eliminated the previous "gross-misconduct or abuse of trust" standard[59] and rejected the stronger "reasonableness" test favored by the SEC.[60] Although this provision allowed courts more flexibility in evaluating the propriety of advisory fees,[61] it failed to specify the factors to be considered in determining whether an advisor violated its fiduciary duty. According to one commentator, however, the legislative history of this provision indicates that in making this determination, a court should consider "the nature . . . and extent of the services rendered to the fund; the extent to which economies of scale and common management were shared with the fund; . . . other income received by the adviser from the fund [including] brokerage commissions, payments for research services, subsidiaries, underwriting fees; . . . [and] the extent of fund recapture of brokerage commissions."[62] Therefore, at least implicitly, the amendments arguably were intended to impose a fiduciary duty on advisors to recapture underwriting fees as well as brokerage commissions.

Prior to the abolition of fixed brokerage commissions in 1975,[63]

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the size of a fee is dependent upon the size of a particular fund's assets. As a fund's assets increase, its fees experience a commensurate percentage growth. PPI, *supra* note 3, at 89. Often the advisor's fees are set at one-half percent of the fund's total assets. This compensation arrangement provides the manager with a bonus whenever the "fund's value increase[s] with a general market rise although such increases in portfolio value might have no relationship to the advising capabilities of the fund's advisory company," but levies no penalty for an advisor's substandard performance. *Strengthening Disclosure, supra* note 56, at 1477. Such an arrangement could promote excessive risk-taking by fund advisors.

58. *See* 15 U.S.C. § 80a-35(b) (1970), which provides in pertinent part: "For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company . . . to such investment adviser or any affiliated person of such investment adviser."

59. In situations involving shareholder contract ratification, the standards of gross-misconduct or abuse of trust imposed on "a plaintiff shareholder . . . the heavy burden of proving waste of corporate assets." Manges, *supra* note 56, at 393.

60. *Id.* The SEC's proposed reasonableness standard was introduced in a 1966 report, PPI, *supra* note 3, at 143-47. The SEC's recommendations were before Congress in 1967 and 1968 but were not included in the final legislation. *See* Manges, *supra* note 56, at 389 & nn.10-11.

61. Manges, *supra* note 56, at 396. The amendments also gave courts the broad discretion to grant necessary and appropriate relief. *Id.*

62. *Id.* Although Manges concludes that these factors are suggested by the ICAA's legislative history, the history itself does not mention explicitly a duty of recapture. *See Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 188 (1969); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970); S. Rep. No. 184, 91st Cong., 1st Sess. 15 (1969).

63. *See* 15 U.S.C. § 78f(e)(1) (Supp. 1977), which provides in pertinent part: "[O]n and

similar concerns were expressed about a fund advisor's duty to recapture brokerage commissions paid by the fund to the advisor's affiliates. In a study entitled Public Policy Implications of Investment Company Growth (PPI), the SEC recommended that advisors be required to recapture such brokerage commissions.[64] Because fixed commissions were not tied to the actual services rendered, they failed to reflect the savings usually inherent in bulk transactions.

Devices such as give-ups, reciprocals, and reciprocity[65] enabled fund advisors to reduce the brokerage commissions indirectly. Through selective usage of these devices, however, these reductions benefited only the advisor, not the fund's shareholders.[66] For example, commissions drawn from the fund's assets were used to finance the broker's research services.[67] Research costs, arguably, are costs of management to be paid for from the advisor's fee rather than from the fund's assets.[68] These devices also were used to reward brokers

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after June 4, 1975, no national securities exchange may impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members. . . . " Until 1975, most rates were non-negotiable under the *N.Y.S.E. Constitution* Art. XV, §§ 2, 7, [1970] NYSE GUIDE (CCH) ¶ 1702, 1707 (rescinded effective April 30, 1976).

64. PPI, *supra* note 3, at 171-73.

65. "Reciprocity," which has been described as the "simplest way to use brokerage commissions to pay brokers," involved the placement of orders by a fund with a broker who received commissions equal to the cost of his services rendered. PPI, *supra* note 3, at 167. A "reciprocal" took place when an advisor made a transaction on the New York Stock Exchange but desired to pay part of the brokerage fees to a broker who lacked membership in the Exchange. The fund would place an order with an Exchange broker who, in turn, would be requested to place sufficient business with the non-Exchange broker to compensate the latter for any services he might have performed. Miller & Carlson, *supra* note 56, at 36 n.6. "Give-ups" occurred whenever funds ordered brokers to surrender portions of their commissions to other brokers. PPI, *supra* note 3, at 169.

66. SEC SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess. (1963); Note, *The Use of Brokerage Commissions To Promote Mutual Fund Sales: Time to Give-up the "Give-Up"*, 68 COLUM. L. REV. 334 (1968).

Merely because the funds paid commissions that were insensitive to economies of scale and therefore higher than the costs of the sellers' services did not mean that fund advisors benefited. Nevertheless, they may have profited if the excessive part of the commission was used to pay for such services as research, which normally is a cost of the advisor and thus computed in his fee. A reduction in advisory fees through recapture would aid a fund in recovering part of the excessive charges it has paid. Moreover, recapture would cause no losses to an advisor who merely would subtract his affiliate's excessive profits from the fees paid by the fund. This process will affect adversely the advisor's profits only if his fee includes amounts retained because fund commissions rather than advisor fees have been used to pay for research.

67. *Conflict of Interest*, *supra* note 46, at 377.

68. The allocation of fees to pay for research may be more acceptable than the distribution of fees to encourage fund sales. The encouragement of fund sales with fee allocations creates

who were diligent in selling the fund's own shares to the public.[69] Since the advisor's fee usually was fixed as some percentage of the value of the fund's assets,[70] the advisor naturally would gain from any increase in the value of the assets, whether the gain was attributable to the appreciation of gains on the fund's investment portfolio or merely to the accumulation of additional capital from the sale of the fund's own shares.[71] Consequently, the decision to direct the fund's brokerage business to one broker rather than to another was often based on the broker's performance in placing the fund's shares rather than his competence in handling the fund's portfolio transactions.[72] Moreover, these arrangements raised serious questions of possible antitrust violations.[73]

Attempting to implement its policies both of promoting commission recapture and of proscribing practices that misled shareholders as to the actual costs of managing funds, the SEC solicited comments on proposed rule 10b-10[75] under the Securities Exchange Act of 1934. Under the rule, "if . . . a mutual fund manager [had] various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he [was] under a fiduciary duty to do so."[76] A manager who made no attempt to recapture excess commissions and apply them toward the advisory fee also risked violation of section 17(e)(1) of the ICA.[77] Presumably,

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a conflict of interest because "managers always benefit from the sale of new fund shares." In contrast, some advisors have contended that, because "investment research is a task intimately connected with the selection of a fund's portfolio," it is an expense that the fund should pay. *Conflict of Interest, supra* note 46, at 377.

69. *Conflict of Interest, supra* note 46, at 372.

70. *See* note 57 *supra.*

71. *Conflict of Interest, supra* note 46, at 375-79.

72. *Id.*

73. *See generally* Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public,* 22 STAN. L. REV. 675, 683 (1970). For a general discussion of antitrust developments in the securities industry during the 1970's, see Pozen, *Competition and Regulation in the Stock Markets,* 73 MICH. L. REV. 317 (1974); Note, *Federal Legislation to Enhance Competition in the Securities Industry,* 16 WM. & MARY L. REV. 621 (1975).

74. *Id.*

75. Proposed rule 10b-10, discussed in Securities Exchange Act Release No. 8239 (Jan. 26, 1968), [1967-1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,523, would have made it unlawful for any investment company manager to direct a broker who executed transactions for the investment company to give up a portion of his compensation to other brokers, unless the amounts given up were returned or otherwise credited to the investment company shareholders.

76. *Id.* at 83,085.

77. *Id.* at 83,085-86. 15 U.S.C. § 80a-17(e)(1) (1970) provides that affiliates of funds, including advisors, must refuse "any compensation . . . for the purchase or sale of any property to

by requiring all funds to recapture excess brokerage commissions, the proposal would prevent some funds from gaining a competitive advantage over others.

The proposed rule became partially obsolete, however, after the New York Stock Exchange (NYSE) sanctioned volume discounts[78] and abolished customer-directed give-ups.[79] Although proposed rule 10b-10 was withdrawn,[80] the SEC still favored recapture when the NYSE volume discount rules were not controlling.[81] Consequently, after years of criticism and study, Congress included a provision in the Securities Acts Amendments of 1975 that required the termination of all fixed commissions on exchanges by May 1, 1975.[82]

The Duty to Recapture and the Courts

Despite shareholder demands, though, fund advisors failed to recapture brokerage commissions. Disgruntled shareholders then sought a remedy in the courts, alleging that this failure to recapture was a breach of the advisor's fiduciary duty.[83] An early suit, *Kurach*

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or for such registered company . . . except in the course of such person's business as an underwriter or broker."

78. Volume discounts first became available in 1968 on orders exceeding 1,000 shares; later, when negotiated commissions were allowed, the discounts were permitted on transactions above $500,000 (later $300,000). For a discussion of these developments, see Papilsky v. Berndt, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,122 (1976).

79. For a review of the SEC's efforts and the NYSE's responses concerning fixed commission rates, see Gordon v. New York Stock Exch., Inc., 422 U.S. 659, 668-82 (1975); Fogel v. Chestnutt, 533 F.2d 731, 734-37, 739-44 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976).

80. Securities Exchange Act Release No. 8746 [1969-1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,761 (Nov. 10, 1969).

81. *Id.*

82. 15 U.S.C. § 78f(e)(1) (Supp. 1977). For the pertinent text of § 78f(e)(1), see note 63 *supra.* An outgoing NYSE Chairman remarked that the termination of fixed brokerage commission rates produced difficulties for the brokerage business. In a newspaper article containing the Chairman's remarks, figures indicated that institutions had saved 39% on brokerage commissions, but individual investors had saved only five percent. Small investors had saved nothing and, in some instances, had been forced to pay higher brokerage commission rates. Brokers suffered a revenue loss of 6.3%, and a number of brokerage firms were forced to merge. Mullaney, *Kolton's Second Thoughts on Negotiated Commissions,* N.Y. Times, July 26, 1977, at 37, col. 2.

83. In Fogel v. Chestnutt, 53 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976), the court noted that "a large number of derivative stockholders actions [were] brought on behalf of mutual funds against investment advisors, distributors, and directors of both, primarily in consequence of [the remarks in the PPI study on recapture]." *Id.* at 734. *See also* Butowsky, *Fiduciary Standards of Conduct Revisited, Moses v. Burgin and Rosenfeld v. Black,* 17 N.Y.L.F. 735 (1971), in which the author estimated that over 50 such suits were filed. *Id.* at 736.

v. Weissman,[84] involved a proposed settlement agreement, characterized by the SEC as "illusory",[85] pursuant to which the defendant, Dreyfus Fund, Inc., would begin recapturing brokerage commissions and would be committed to amassing an amount equal to at least one million dollars over the succeeding five years. No provision was made for compensating the plaintiffs retroactively for the defendant's prior failure to recapture. The district court denied the plaintiffs' cause of action, reasoning that, because section 17(e) of the ICA allows affiliates of the fund's advisor to receive commissions from fund transactions,[86] they also could prevent their recapture.[87]

The Court of Appeals for the First Circuit, in *Moses v. Burgin*,[88] described as the "first thorough examination of recapture and its associated issues,"[89] held that the fiduciary duty of fund managers imposed by section 36 of the ICA included the obligation to disclose to independent directors the possibility of a conflict of interest in the managers' failure to recapture available funds.[90] Rejecting prior cases denying recovery, the court concluded that the use of brokerage commissions to finance the sale of the fund's own shares benefited only the fund advisor while impairing the capital contributed by shareholders. The court stated: "The existing shareholders have contributed—by paying more than otherwise necessary on fund's portfolio transactions—to the cost of the sale, which was supposed to have been borne by the new member alone."[91] Simultaneously,

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84. 49 F.R.D. 304 (S.D.N.Y. 1970).

85. *Id.* at 307.

86. *Id. See* 15 U.S.C. § 80a-17(e)(1) (1970).

87. Pertinent to the court's decision was its conclusion that the plaintiff's chance of success was minimal if the case was to be tried because no recovery had yet been granted in an excessive management fee case. 49 F.R.D. at 306-07.

88. 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971).

89. Comment, *Settlement Standards for Mutual Fund Shareholder Litigation Involving the Fiduciary Obligation to Recapture*, 13 B.C. INDUS. & COM. L. REV. 1039, 1046 (1972).

90. *Id.* at 384. *See* 15 U.S.C. § 80a-35 (1970) (amended 1975). One method by which Congress sought to curb abuses of the ICA by mutual fund advisors was to require that no more than 60% of a fund's directors be interested persons. *Id.* at § 80a-10(a) (1970). One commentator identified both Congress' intent and the chief criticism of the system: "The principal safeguard . . . against overreaching . . . is . . . the unaffiliated director . . . . [But] [t]he men who need to be watched pick the watchdogs to watch them." Comment, *The Mutual Fund Management Fee*, 115 U. PA. L. REV. 726, 739 (1967). For analysis of the responsibilities of these independent directors, see Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors*, 115 U. PA. L. REV. 1058 (1967); Comment, *Mutual Funds and Independent Directors*, 1972 DUKE L. J. 429; Comment, *Duties of the Independent Director in Open-End Mutual Funds*, 70 MICH. L. REV. 696 (1972).

91. 445 F.2d at 374.

with these excessive contributions, the court observed, the fund's net assets were increased, thereby augmenting the fund manager's fee.

After reviewing the increasing SEC and congressional involvement in the recapture issue, Judge Aldrich, writing for the court, determined that the fund managers knew of feasible legal methods of recapture but failed to inform the independent directors of the potential application of these practices.[92] Although the SEC proposed rule 10b-10 after commencement of the suit, the fund directors, led by the interested members, failed to approve the recapture of give-ups until a week before their use was abolished.[93] Responding to testimony that proposed rule 10b-10 was a "bombshell" to management, the court stated: "After the . . . SEC proceedings . . . and the 1966 PPI report, the bomb's fuse had been audible to management for a long time."[94]

Addressing the recapture issue after the abolition of fixed brokerage commissions, the Court of Appeals for the Second Circuit, in *Fogel v. Chestnutt*,[95] rejected the defendant's contention that because recapture was neither feasible nor legal, they were under no duty to inform the fund's independent directors of the potential for recapture.[96] In its repudiation of the illegality argument, which was founded on the amicus' interpretation of the exchanges' anti-rebate rules, the court stated that "recapture by a fund was a method, then the only available method, for avoiding the payment of advisory and selling costs exceeding those stipulated in its management contracts."[97] Rather than providing a rebate to customers, recapture served only to prevent the commissions paid by the fund on portfolio business from being used to remunerate fund managers indirectly.

92. *Id.* at 378-79.

93. Although Rule 10b-10 was proposed on January 26, 1968, *see* note 75 *supra*, until December 5, 1968, give-ups still were permissable under the rules of the Philadelphia-Baltimore-Washington and Pacific exchanges. 445 F.2d at 380-81.

94. *Id.* at 381.

95. 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976).

96. *Id.* at 750-55.

97. *Id.* at 754. The court observed that "none of the arrangements would have resulted in the Fund's paying less than the stipulated commission rates," *id.* at 753, and that

> [t]he situation was not one in which recapture would result in an adviser's obtaining services at less than cost whereas other paid the full cost; such unfairness as there was in recapture lay in the fact that advisers to mutual funds were not the only customer who should have benefited from the size of their orders.

Id. at 754.

Moreover, management directed give-ups to brokers who either provided research or sold the fund's shares did not violate these anti-rebate rules, although such payments necessitated the relinquishment of some unearned portions of the brokerage commissions. The court concluded that neither the SEC's policy opposing institutional exchange memberships nor the Securities Acts Amendments of 1975's prohibiting such memberships proved that recapture was illegal:[98]

> Congress simply decided that in the brave new world of negotiated rates, brokers serving the public should have the benefit of institutional business and that there was no need for institutional membership when the negotiated rate system would allow an institution to have its orders executed at charges that bore a reasonable relation to the services actually rendered.[99]

In *Tannenbaum v. Zeller,*[100] the most recent case to consider the brokerage fee recapture issue, the Court of Appeals for the Second Circuit held the defendant-advisor liable for failing to disclose the possibility of recapturing brokerage commissions in proxy statements to the shareholders of Chemical Fund, Inc.[101] The court, however, rejected several theories of liability advanced by the plaintiff. First, the plaintiff argued that the fund advisor's failure to recapture violated the management and distribution contracts between the fund and the advisor. In rejecting this contention, the Second Circuit noted that the agreements made no reference to the allocation of excess brokerage commissions.[102] The court thereby accepted the defendant's uncontradicted testimony that the use of excess commissions to pay for services was "implicit in the negotiation of the management fee."[103]

The plaintiff next argued that the fund's certificate of incorpora-

98. *Id.* at 755. In 1972, the SEC promulgated rule 19b-2 prohibiting those institutions not transacting at least 80% of their business in public securities from acquiring membership on exchanges. 38 Fed. Reg. 3928 (1973) (formerly codified in 17 C.F.R. § 240.19b-2). This rule was designed to prevent the inequity of permitting membership only for the purpose of recovering excess commissions. The Securities Amendments Act of 1975 adopted a slightly different position, preventing exchange members from effecting transactions for their own account. *See* 15 U.S.C.A. § 78k(a) (Supp. 1977).

99. 533 F.2d at 755.

100. 552 F.2d 402 (2d Cir. 1977).

101. *Id.* at 429-34.

102. *Id.* at 414.

103. *Id.* at 415.

tion, requiring it to receive "not less than 'net asset value' for each share sold," was violated when the advisors used brokerage commissions to reimburse dealers for sales and research.[104] The First Circuit had accepted this rationale in *Moses v. Burgin*, holding that the use of excessive brokerage fees to promote fund sales essentially enabled new purchasers to buy at a discount below true asset value.[105] In *Tannenbaum*, however, the court agreed with the reasoning in *Fogel*,[106] decided two years earlier by a different panel of the court, that this argument overstated the effect of the fund's failure to recapture.[107]

The court also disagreed with the plaintiff's argument that the advisor's failure to recapture constituted a breach of a fiduciary duty. The ICA imposed no absolute duty to recapture excess brokerage fees.[108] Moreover, because a sufficient disclosure to the fund's independent directors had been made, the decision to forego recapture was merely a justifiable exercise of informed discretion.[109] The court concluded, however, that, because the proxies failed to reveal that brokerage commissions were used to finance the sale of fund shares and research and neglected to mention the feasibility of recapture, the means available for recapture, or the directors' reasons for failing to recapture,[110] the proxies were false and misleading.[111]

In *Papilsky v. Berndt*[112] the District Court for the Southern District of New York examined whether mutual fund managers have a fiduciary duty to disclose to the fund's independent directors the possibility of recapturing underwriting fees. The court found that the fund advisor, Lord, Abbett and Co., failed to fully inform the board of directors of the feasibility of underwriting commission re-

104. *Id.* at 416.

105. 445 F.2d at 374.

106. 533 F.2d at 744.

107. 552 F.2d at 416.

108. *Id.* at 417.

109. *Id.* at 413-28. The court established a three-part test to determine whether a fund's directors or advisors violated their fiduciary obligation under § 36 of the ICA, 15 U.S.C.A. § 80a-35 (1971 & Supp. 1977). The evidence must establish that the independent directors:

> (1) were not dominated or unduly influenced by the investment advisor; (2) were fully informed by the advisor and interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors.

552 F.2d at 418 (footnote omitted).

110. *Id.* at 433.

111. *Id.* at 434.

112. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,121 (1976).

capture.[113] The possibility of recapture, together with the fund attorney's advice that such action could create "serious legal risks", had been mentioned at only one directors' meeting. According to the defendants, the recapture of underwriting commissions arguably violated the rules and policies of the National Association of Security Dealers (NASD), of section 17(a) of the ICA, and of the investment restrictions in the fund's charter. The court noted, however, that neither the SEC nor the NASD had construed the law and rules in the manner suggested by the defendants.[115] Because the potential for conflicting interests was sufficiently great, the independent directors not only should have been informed fully of the possibility of recapture but, if necessary, have been given access to disinterested counsel to assist in analyzing the legal risks created by recapture.[116] Rather than complying with its duty to disclose, however, Lord, Abbett and Co. informed the independent directors that recapture was illegal.[117] The court concluded, consistent with precedent in the First and Second Circuits, that the fund managers' failure to consider objectively the possibility of underwriting fee recapture constituted a breach of its fiduciary duty.

This conclusion is undermined by three factors. First, in contrast to *Papilsky,* the district court in *Moses v. Burgin* held that recapture would violate the NASD Rules of Fair Practice.[118] Although the First Circuit reversed the district court's decision, because the plaintiffs failed to challenge on appeal the lower court's conclusion that the recapture of underwriting fees is prohibited, that portion of the district court's decision remains viable. Thus a conflict among the circuits is created. Second, section 21(2) of the Security Acts Amendments of 1975 authorizes the use of brokerage commissions to pay for research, provided that such action does not deceive the fund shareholders and that the payments represent reasonable compensation for the services performed.[119] The provision's failure to

113. *Id.* at 90,132-35.

114. 15 U.S.C. § 80a-17a (1970).

115. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,130-32.

116. *Id.* at 90,133.

117. *Id.* at 90,134.

118. 316 F. Supp. 31, 47-48 (D. Mass. 1970), *rev'd on other grounds,* 445 F.2d 369 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971).

119. 15 U.S.C.A. 78bb(e)(1) (Supp. 1977). Section 78bb(e)(1) provides in pertinent part:

> No person . . . shall be deemed to have acted unlawfully or to have breached a fiduciary duty . . . solely by reason of his having caused [an] account to pay a member of an exchange, broker, or dealer an amount of commission for effect-

mention excessive underwriting commissions as a source from which research expenses could be paid may indicate that Congress would distinguish questions involving underwriting fees from those concerning brokerage commissions.[120] Thus, although Congress might authorize the recapture of brokerage commissions, it might condemn a similar use of underwriting fees. Third, the court's conclusion in *Papilsky* was conditioned upon the absence of legal impediments imposed by the NASD and SEC underwriting rules. As discussed in the next section, however, the NASD has interpreted its rules as preventing recapture, thus weakening the viability of *Papilsky*.

Legal Impediments to the Recapture of Underwriting Commissions

Several objections to recapture by muni-funds arise from the laws and rules governing underwriting and from the laws and rules controlling muni-fund portfolio purchase procedures. Though the latter, more direct type of legal restrictions may be avoided by obtaining an exemption from the SEC, others may not be avoided so readily.

The primary legislation affecting underwriting procedures is the Securities Exchange Act of 1934 and the Securities Act Amendments of 1975 (SAA).[121] Pursuant to these enactments, two self-regulatory bodies have been established; the National Association of Securities Dealers (NASD), regulating the private equity security market, and the Municipal Securities Rulemaking Board (MSRB), performing similar duties in the municipal securities market.[122]

> ing a securities transaction in excess of the amount of commission another member . . . would have charged . . . if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.

120. One commentator has suggested that § 21(2) may be interpreted as providing an implied congressional authorization for using both underwriting fees and brokerage commissions to pay for research. Note, *The Relationship between the Investment Adviser and the Mutual Fund: Too Close for Comfort,* 45 FORDHAM L. REV. 183, 200 (1976).

121. The Securities Exchange Act of 1934 is codified at 15 U.S.C. §§ 78a-78hh (1970). The SAA, Pub. L. No. 94-29, 89 Stat. 97 (1975), amends many parts of the securities code and is codified in scattered sections of 15 U.S.C.A. (Supp. 1977).

122. The NASD was authorized and registered pursuant to 15 U.S.C.A. § 78*o*-3 (1971 & Supp. 1977). The MSRB was established pursuant to *id.* § 78*o*-4 (Supp. 1977). Until the SAA were enacted in 1975, municipal bond dealers were virtually unregulated. Section 3(2) of the SAA, however, amended the definition of "person" contained in the Securities Exchange Act

The NASD, as the self-regulatory body for the private securities market, does not govern the practices of those persons working in the municipal bond field. Nevertheless, its positions and rules are important indicators of attitudes toward recapture in the related municipal securities market because the MSRB and the NASD are subject to the same legislative mandate, preventing "unfair discrimination between customers."[123] This statutory language has prompted NASD's condemnation of recapture.[124] The MSRB, however, has not adopted a similar rule or interpretation preventing recapture by muni-funds; instead, its rule could be interpreted to sanction a muni-fund's recapture of underwriting fees from their affiliates.[125] This interpretation would resolve anticipated problems

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of 1934 to include state and local governments, *id.* § 78c(a)(9), thus subjecting professionals dealing in municipal securities to the terms of the 1934 Act. Despite this explicit redefinition, the SEC contends that the anti-fraud provisions of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970), had always applied to persons involved in trading municipal securities. *See* S. REP. No. 75, 94th Cong., 1st Sess. 46, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS 179, 224.

Governments issuing bonds always have been exempted from the provisions of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970). *See* Securities Act of 1933, § 3, 15 U.S.C. § 77c(a)(2) (1970), which provides in pertinent part: "[T]he provisions of his subchapter shall not apply to any . . . security issued or guaranteed . . . by any State of the United States, or by any political subdivision of a state or territory, or by any public instrumentality of one or more States or territories . . . . " The rationale for this exemption is unclear. *See* Doty & Petersen, *The Federal Securities Laws and Transactions in Municipal Securities,* 71 NW. U.L. REV. 283, 286 n.10 (1976). A lawyer who assisted in drafting the Act subsequently wrote that "[m]unicipal bonds, which we sought to include in our original draft, were made exempt for obvious political reasons." Landis, *The Legislative History of the Securities Acts of 1933,* 28 GEO. WASH. L. REV. 29, 39, (1959).

The tremendous expansion of individual investment in the municipal securities market and the concomitant increase in fraudulant trading practices induced Congress to promulgate a comprehensive regulatory scheme with its enactment of the SAA. Nevertheless, the new amendments still prevent the SEC and the MRSB from requiring either directly or indirectly through a dealer or broker that an issuer of municipal securities submit resale information to the SEC, the MSRB, or to any prospective purchaser. 15 U.S.C.A. § 78o-4(d)(1)-(2) (Supp. 1977). Rather, the MSRB may require brokers and dealers to furnish it or prospective purchasers with information concerning the issuer that generally is available from a source other than the issuer. *Id.* § 78o-4(d)(2). For an analysis of the SAA, see Doty & Petersen, *supra,* at 298-302, 343-48; Note, *Federal Regulation of Municipal Securities,* 60 MINN. L. REV. 567 (1976).

123. 15 U.S.C.A. §§ 78o-3(b)(6), 78o-4(b)(c) (Supp. 1977).

124. *See e.g.,* Letter of Frank J. Wilson (Dec. 6, 1976), *distributed in* Investment Company Institute Members Notice 70-76 (Dec. 17, 1976); NASD, Notice to Members 77-31 (Sept. 23, 1977). For a discussion of matters generally related to the NASD Rules of Fair Practice, see the interpretations in the Rules, NASD MAN. (CCH).

125. Rule G-11(b), Order Approving Proposed Rule Change, Securities Exchange Act of 1934 Release No. 15090 (Aug. 25, 1978), provides in pertinent part:

in the underwriting procedure through disclosure—requiring a municipal securities dealer, when submitting his order to an underwriting syndicate, to divulge whether he is buying on behalf of an affiliated portfolio.[126] Disclosure alone, of course, does not bar recapture from an affiliate.

The principal argument against permitting the recapture of underwriting fees in the private securities market is that such a practice would violate NASD Rule of Fair Practice 24,[127] which allows discounts, selling concessions, and other allowances only as consideration for services rendered in distribution and only to brokers or dealers engaged in the investment banking or securities business. This rule assures all buyers the opportunity to purchase securities on the same terms. The contention that Rule 24 prohibits underwriting fee recapture is based on the theory that recapture would permit mutual funds to obtain a discount unavailable to other purchasers of the new securities.[128] Conversely, it may be argued that recaptured fees are not returned to the investors but are used to offset the advisor's excessive management fee, and therefore, Rule

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> (b) Disclosure of Capacity. Every municipal securities dealer that submits an order to a syndicate or to a member of a syndicate for the purchase of municipal securities held by the syndicate shall disclose at the time of submission of such order if the securities are being purchased for its dealer account, for the account of a related portfolio of such municipal securities dealer, for a municipal securities investment trust sponsored by such municipal securities dealer, or for an accumulation account established in connection with such a municipal securities investment trust. The senior syndicate manager shall promptly disclose to the other members of the syndicate, upon request made prior to final settlement of the syndicate account, each order submitted for such a related portfolio, municipal securities investment trust, or accumulation account, indicating the identity of the . . . related portfolio, . . . municipal securities investment trust, or . . . accumulation account, . . . the aggregate face amount of each maturity and the maturity dates of the securities which are the subject of the order.

126. *Id.*

127. Rule 24 of the NASD Rules of Fair Practice, NASD MAN. (CCH) ¶ 2174, at 2098, provides:

> Selling concessions, discounts, or other allowances, as such, shall be allowed only as consideration for services rendered in distribution and in no event shall be allowed to anyone other than a broker or dealer actually engaged in the investment banking or securities business; provided, however, that nothing in this rule shall prevent any member from selling any security owned by him to any person at any net price which may be be fixed by him unless prevented therefrom by agreement.

128. For a comprehensive analysis concluding that recapture constitutes price discrimination, see NASD, Notice to Members 77-31 (Sept. 23, 1977).

24 does not prohibit recapture.[129] The issue, then, is whether a fund obtains a discount when its advisor's fee is reduced in proportion to commissions or concessions received by the advisor or an affiliate.

As previously discussed, the New York district court in *Papilsky* summarily rejected the argument that underwriting commission recapture by an equity fund violated Rule 24.[130] In reaching this conclusion, the court relied on *Fogel,* in which the Second Circuit, in a similarly cursory manner, declined to hold that a tender offer fee recapture violated Rule 24.[131] But responding to *Papilsky,* the NASD stated that underwriting fee recapture was precluded by Rule 24, thereby significantly undermining that case's viability.

The NASD's strong opposition to underwriting fee recapture reflects its Board of Governors' decision that the practice would create a special class of investors, the mutual funds, who could purchase securities at a price more favorable than that available to the public.[132] A reduction of the fund advisory fee through recapture, the Board determined, was indistinguishable from a direct discount accomplished by lowering the security's purchase price.[133] Because a fund was not "a broker or dealer actually engaged in the investment banking or securities business" within the meaning of the NASD bylaws, it could not qualify for a selling discount under Rule 24.[134] Finally, the Board determined that recapture would constitute preferential treatment, subject to disclosure under NASD Rule of Fair Practice 7.[135]

The SEC has indicated, though, that, prior to their implementa-

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129. The court in *Fogel* discussed this argument in the context of brokerage commissions. 533 F.2d at 753-54; *see* note 97 *supra* & accompanying text.

130. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,131. For a discussion of *Papilsky,* see text accompanying notes 112-17 *supra.*

131. 553 F.2d at 752 n.25. For a discussion of *Fogel,* see notes 95-99 *supra* & accompanying text.

132. The NASD initially announced its position in letters responding to requests for interpretation of Rule 24 from the counsel of fund organizations. Letter of Frank J. Wilson (Dec. 6, 1976), *distributed in* Investment Company Institute Members Notice 70-76 (Dec. 17, 1976). *See also* NASD, Notice to Members 77-31 (Sept. 23, 1977).

133. Letter of Frank J. Wilson (Dec. 6, 1976), *distributed in* Investment Company Institute Members Notice 70-76 (Dec. 17, 1976), at 2-3.

134. *Id.* at 3.

135. *Id.* Rule 7 of the NASD Rules of Fair Practice, NASD MAN. (CCH) ¶ 2157, at 2075, provides: "Selling syndicate agreements or selling group agreements shall set forth the price at which the securities are to be sold to the public or the formula by which such price can be ascertained, and shall state clearly to whom and under what circumstances concessions, if any, may be allowed."

tion, NASD's rules must be approved by the SEC.[136] As SEC Secretary George Fitzsimmons has stated, the policy of the NASD places "[i]nvestment companies and their advisers . . . in a dilemma: there will be liability under the *Papilsky* doctrine or penalties under the NASD Rules of Fair Practice."[137]

A second argument against the legality of underwriting fee recapture is that it violates Rule 1 of the NASD Rules of Fair Practice, which states that "[a] member . . . shall observe high standards of commercial honor and just and equitable principles of trade."[138] Invoking this rule, the NASD Board of Governors has disallowed the sale of securities in a "hot issue" offering to the vendor's employees, officers, and other associates.[139] Considered manipulative by the NASD, this practice was barred in a 1970 construction of Rule 1.[140]

In *Papilsky*[141] the defendants argued that the NASD's interpretation of Rule 1 required all securities in a public offering to be sold at one price, free from any premiums or discounts. Because recapture effectively created a discount, the defendants contended, it was proscribed by Rule 1.[142] The court regarded the NASD interpretation merely as a response to the "hot issue" problem and concluded

136. The SEC requested that the "interpretation . . . be filed, as soon as practicable and in any event not later than April 4, 1977, as a proposed rule change for thorough consideration in accordance with the procedures specified in Section 19(b)(2)(B) of the Securities Exchange Act of 1934." Letter from SEC Secretary George Fitzsimmons to NASD President Gordon S. Macklin (Feb. 17, 1977), at 3. The NASD's proposed changes in Rule 24, outlined in NASD, Notice to Members 77-31 (Sept. 23, 1977), are not a response to the SEC request for a formal rule change. Rather, the Notice reiterates the NASD's position on recapture and outlines proposals to terminate abuses in the use of underwriting allowances, selling concessions, and discounts.

137. Letter from SEC Secretary George Fitzsimmons to NASD President Gordon S. Macklin (Feb. 17, 1977), at 3. Moreover, the possibility of a direct conflict between the SEC and the NASD on the correct interpretation of Rule 24 is suggested by Fitzsimmon's statement that "[p]rior Commission decisions cast doubt on the NASD's authority to adopt a rule having the effect which the NASD's interpretation would give to Section 24." *Id.* at 2 (footnote omitted).

138. NASD Rules of Fair Practice, NASD MAN. (CCH) ¶ 2151, at 2039.

139. The practice of selling securities to the underwriter's associates in an attempt to take advantage of the "hot issues" or securities in short supply became a serious problem in the late 1960's. An employee, officer, or associate of the selling underwriter or broker would hold the securities for later resale in the secondary market. As a result, a substantial profit often would redound to the selling underwriter or broker. W. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS 201 (1974).

140. NASD Rules of Fair Practice, (Interpretation of the Board of Governors), NASD MAN. (CCH) ¶ 2151, at 2039.

141. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,131.

142. *Id.*

that the defendants' proposed construction was unnecessarily broad.[143] Recapturing underwriting commissions, the court maintained, did not permit the fund to hold securities for subsequent sale to benefit the syndicate or selling group. Rather, "[an advisor] like any other NASD member designated by it, would be a member of the selling group for the sole purpose of receiving underwriting commissions; it would not be making a public distribution any more than any other NASD member so designated would be."[144]

Another argument against the legality of recapture, unrelated to either the NASD or the MSRB rules, is that recapture is inconsistent with mutual fund charters. Delimiting a fund's operations to the statutorily authorized activities of investment companies, these charters prohibit the funds from serving as underwriters.[145] Arguably, a violation of the charter results whenever a fund's advisor becomes a member of a selling group or syndicate because both the advisor and the fund act as underwriters. In *Papilsky* the court rejected this argument,[146] reasoning that "[t]here is no reason to think, apart from a too heavy reliance on form over substance, that the designation of Lord, Abbett [the advisor] rather than another broker-dealer to receive the commissions would have turned Affiliated Fund into an underwriter."[147] Importantly, because the fund in *Papilsky* did not receive a commission but merely obtained a reduction in its advisory fee obligation, it could not have been regarded as an underwriter.

Similarly, the laws governing the purchase of new issues by mutual funds raise additional legal impediments to recapture. Sections 17(a)[148] and 10(f)[149] of the ICA proscribe transactions between funds

143. *Id.*

144. *Id.*

145. *See, e.g.,* Papilsky v. Berndt, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,131 (1976); PPI, *supra* note 3, at 45.

146. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,131.

147. *Id.* at 90,132.

148. 15 U.S.C. § 80a-17(a) (1970). Section 17(a) provides in pertinent part:

> It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 12(d) (3) (A) and (B)), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—
>
> (1) knowingly to sell any security or other property to such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities

and their advisors, the advisor's affiliates, or syndicates in which the advisors and affiliates participate as underwriters. Although funds observing certain safeguards, such as purchasing in limited quantities only SEC registered securities,[150] are exempted from these proscriptions, these exceptions apply only to investment companies purchasing corporate securities, not to muni-funds.

The restrictions imposed by the ICA on the purchase of bonds by muni-funds not only prevent recapture but also limit severely a fund's investment options. Although the restrictions imposed by the ICA prevent an equity or corporate bond fund from purchasing a security from a syndicate, the fund may purchase the security on the secondary market. In contrast, the manager of a muni-fund often lacks this alternative because many small, high-yield municipal bonds are not sold on the secondary market.[151] Moreover, since advisors frequently are affiliated with firms underwriting numerous municipal bond offerings, a general restriction preventing a fund from purchasing new issues from its advisor's affiliate's syndicate excludes certain funds from a substantial segment of the bond market.[152]

> or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof . . . .

Subsections (d) and (e) of § 17 might also affect proposed recapture transactions. *See id.* § 80a-17(d) to (e). Section 17(d) requires that a fund's participation in a joint enterprise with an affiliate be conducted in a manner that places the fund in at least the same position as the other participants, and § 17(e) bars a fund affiliate acting as a broker from receiving compensation from a fund in excess of specified amounts.

149. *Id.* § 80(a)-10(f). Section 10(f) provides in pertinent part: "No registered investment company shall knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security . . . a principal underwriter of which is an officer, director . . . adviser, or . . . affiliated person." The SEC may exempt any transaction or class of transactions from these restrictions "if such exemption is consistent with the protection of investors." *Id.*

150. *See* 17 C.F.R. § 270.10f-3 (1977), which provides in pertinent part:

> Any purchase of securities by a registered investment company prohibited by section 10(f) of the act shall be exempt [provided]
>
> (a) The securities . . . are . . . registered. . . .
>
> (b) The . . . spread . . . shall not exceed: . . . (3) 1.50 percent of the . . . price . . . of any other security to be purchased.
>
> (c) The issuer . . . shall have been in continuous operation for not less than three years . . . .
>
> (d) The amount of securities of any class of such registered issue . . . shall not exceed 3 percent of the amount of the offering of such class.

151. *See* R. Robinson, Postwar Market for State and Local Government Securities 11-12 (1960). *See also* Securities Industry Association, Fundamentals of Municipal Bonds (G. Calbert ed. 1972); Doty & Petersen, *supra* note 122, at 317-19.

152. For example, these restrictions prevent the Merrill, Lynch Municipal Bond Fund from

The problem of the investment options limitation has been brought to the SEC's attention by several funds petitioning for exemptions from sections 10(f) and 17 of the ICA.[153] In granting exemptions to section 10(f), the SEC has imposed several restrictions on mutual funds for the protection of investors, differing in important respects from those imposed on equity funds seeking similar exemptions. First, analogous to the equity fund exemption requirement that securities bought from affiliates' syndicates be registered with the SEC, municipal bonds purchased by muni-funds must be appraised by a recognized bond rating service such as Standard & Poor's or Moody's.[154] In addition, if the issue has received a rating of at least "A", the fund may ignore the requirement that the issuer be in existence for at least three years prior to the purchase of the securities.[155] Strict adherence to this three-year requirement would prevent muni-funds from buying from their affiliates' syndicates bonds issued by public authorities organized to finance new facilities. Finally, the quantity limitations pertaining to muni-funds were increased, exceeding the three percent of a particular offering limitation applicable to equity funds receiving exemptions.[156] Municipal bond issues are often substantially smaller than corporate issues,

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purchasing a "significant portion" of all underwritten issues. *See* Notice of Filing of Application Pursuant to § 10(f) of the Act Exempting Certain Transactions from the Provisions of § 10(f), *In re* Merrill, Lynch Municipal Bond Fund, Inc., SEC Investment Co. Act of 1940 Release No. 9779 (May 26, 1977), SEC Docket 706 (June 12, 1977) [hereinafter cited as Merrill, Lynch Notice].

153. *See, e.g.,* Application for an Order Pursuant to § 6(c), § 10(f), & § 17(b) of the Investment Company Act of 1940, *In re* Pennsylvania Tax-Free Income Trust Release No. 9784 (May 31, 1977), SEC Docket 706 (June 12, 1977) [hereinafter cited as Pennsylvania Trust Application]; Merrill, Lynch Notice, *supra* note 152.

154. In one instance the applicants requested a modification of rule 10f-3, 17 C.F.R. § 270.10f-3 (1977), *see* note 150 *supra,* to limit purchases to securities that had received an "investment grade rating from a recognized bond rating service." *Pennsylvania Trust Application, supra* note 153. To date, however, the SEC has limited its exemptions to the purchase of bonds with at least an "A" rating. *See, e.g.,* Order Pursuant to § 10(f), *In re* Merrill, Lynch Municipal Bond Fund, Inc., Release No. 9870 (July 27, 1977), SEC Docket 1406 (August 9, 1977) [hereinafter cited as Merrill, Lynch Order]; Order Pursuant to § 10(f) of the Act Exempting Certain Transactions from the Provisions of § 10(f), *In re* Pennsylvania Tax-Free Income Trust, Release No. 9871 (July 28, 1977), SEC Docket 1407 (August 9, 1977) [hereinafter cited as Pennsylvania Trust Order].

155. Merrill, Lynch Order, *supra* note 154. For a description of the requirements imposed on equity funds seeking exemptions, see note 150 *supra.* Another resolution to this problem may have been to require that issuers file with the SEC information similar to that necessary for registration. Such a practice, however, would contravene the statutory policy against issuer registration. *See* note 122 *supra.*

156. *See* note 150 *supra.*

and a limitation of three percent could reduce a potential investment below the fund's purchase minimum. Therefore, the SEC now allows municipal bond purchases of three percent of the issue or $500,000, whichever is higher, but not to exceed ten percent of the issue.[157]

A counterpart to section 10(f) of the ICA is section 17(a), which prevents the fund's principal underwriter or any affiliated person from selling securities to the fund.[158] As previously noted, the defendants in *Papilsky* argued that by designating underwriting commissions to an advisor, the advisor must be reclassified as a member of the syndicate or selling group, thereby becoming a seller in violation of section 17(a).[159] Whether the defendant was considered as a designatee of underwriting commissions for the benefit of the fund or as a designator of commissions through its designee-agent, "the asserted legal danger [of being deemed a seller] was no more real."[160] The court could ascertain "no sound reason of pertinent law or policy to strain in this way to uphold defendant's diversion of commissions for their own benefit rather than the benefit of the shareholders."[161] Nevertheless, the court noted that the defendants could have sought a section 17(b) exemption because the transactions were "reasonable and fair and [did] not involv[e] overreaching."[162]

Inasmuch as the SEC has not yet issued exemptive orders under section 17 for recapture transactions, the court's holding in *Papilsky* remains the only definitive interpretation of section 17(a). Some developments suggest, however, that the SEC ultimately will require funds to obtain section 17 exemptions. For example, the SEC has restricted the exemptions granted to muni-funds under section 10(f) by requiring that they consider the feasibility of recapturing the costs of portfolio transactions and seek section 17 exemptions.[163] Such recapture might be undertaken whenever the interested directors determine that it is in the fund's best interests or if "otherwise required by developments in the law."[164]

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157. Merrill, Lynch Order, *supra* note 154.

158. 15 U.S.C. § 80a-17(a) (1970). For the text of § 17(a), see note 148 *supra*.

159. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,131. *See* text accompanying notes 112-17 *supra*.

160. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627, at 90,131.

161. *Id.*

162. *Id. See* ICA, § 17(b)(1), 15 U.S.C. § 80a-17(b)(1) (1970).

163. *See* Merrill, Lynch Order, *supra* note 154; Pennsylvania Trust Order, *supra* note 154.

164. Merrill, Lynch Order, *supra* note 154; Pennsylvania Trust Order, *supra* note 154.

The standards for a section 17 exemption could be less detailed than those existing under section 10(f), reflecting legal and policy decisions as to whether transactions allowing recapture are fair to fund investors. Thus, for muni-funds at least, although recapture must be considered seriously because the advisor may have a fiduciary duty to inform the independent directors of its feasibility, it will not be permitted by the SEC until that agency finally acts on the section 17 exemption applications. The ultimate solution to the conflict over recapture, therefore, not only should entail a definitive interpretation of section 17 but also should resolve the differing viewpoints presented by the SEC, the NASD, and the district court in *Papilsky*. As a result of the conflicting policies of the MSRB and the NASD toward recapture, however, the subject may be resolved differently by the two sectors of the financial industry regulated by these bodies.

Conclusion

The legislation permitting the pass-through of tax-exempt municipal bond interest apparently was approved without sufficient study to anticipate the current regulatory problems. Because muni-funds potentially may invest billions of dollars in the municipal bond market, the need for reexamination of the muni-fund concept is urgent. In the past several years, Congress has sought new ways to raise revenues, to encourage tax equity, and to reform existing tax exemptions by imposing minimum taxes on previously untaxed investments. Rather than promoting any of these objectives, the successful operation of muni-funds may create an insurmountable barrier to the elimination of the municipal bond interest exemption.

The growing popularity of muni-funds also highlights the problems created by fixed underwriting commissions. Both the SEC and the MSRB, as regulators of muni-funds, have an opportunity to require funds to consider the recapture of excessive underwriting commissions. As a condition for exempting funds from laws prohibiting the sale of new issues by advisors and affiliates to their funds, advisors' may be required to recapture whenever feasible. Because recapture is available only to purchasers who are members of a syndicate or selling group, funds engaging in recapture arguably receive a sales concession or a discount that is unavailable to others. The SEC consequently should consider the abolition of fixed underwriting commissions. This would provide all large purchasers, not just mutual funds, with the ability to take advantage of the economies of scale created by large transactions. In the interim, the SEC and the NASD should consider whether fund advisors are receiving benefits from practices such as designated orders at the expense of their funds.