

REGULATING DISCRETIONARY MANAGEMENT: BROKER-DEALERS AS CATALYSTS FOR REFORM

HARVEY E. BINES*

Over the last decade, there has been a remarkable increase in the number of broker-dealers offering or promoting discretionary management services.¹ In "discretionary" accounts, authority is granted an investment manager to make investment decisions and execute them for the benefit of a client without the obligation of consulting with, or obtaining prior approval from, the client.² An increasing number of houses are offering discretionary management services directly or through affiliates, and they are actively soliciting clients to turn their accounts over for expert management. Other broker-dealers, not offering discretionary management services themselves or through affiliates, are referring customers to investment advisers who in turn pay compensation for the referrals or rely on referring broker-dealers for executions and custody of client accounts.³

* B.S., 1963, Massachusetts Institute of Technology; J.D., 1970, University of Virginia; Associate Professor of Law, University of Virginia.

This article, in a modified form, will appear in a book on the law of investment management to be published by Warren, Gorham & Lamont, Inc. I wish to express my gratitude to friends and colleagues who read this manuscript before publication and to members of the staff of the Division of Investment Management Regulation of the SEC with whom I worked last summer. Responsibility for the ideas expressed here is mine, but the value of their influence should not be underestimated. I also am deeply indebted to Stephen R. Kruff of the University of Virginia, class of 1975, for the invaluable research and editorial assistance he provided in the preparation of this article.

¹ In 1962, national securities exchange members earned profits of \$11.2 million from investment advisory services, while the total in 1969 was \$43.6 million. In the latter year, ten percent of the members of the New York Stock Exchange had advisory-fee income totaling five percent or more of their commission income, while two percent of the firms derived twenty-five percent or more of their commission from that source. SEC, Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2297 (1972) [hereinafter cited as Institutional Investor Study]. The broker-dealer who manages discretionary accounts may gain a significant competitive advantage over other firms that serve only as brokers. See Wells, *Should Money Management and Brokerage Be Separated?*, Institutional Investor, June, 1971, at 22. Some firms have begun to specialize in combining the duties of the broker-dealer with those of the adviser or manager. See Bernstein, *The Specialized Brokerage Firm and the Discretionary Account*, in Institutional Investors in a Changing Economy 231 (PLI 1970). Such firms, however, may face a difficult future, because pending legislation would prohibit them from executing many transactions in listed stocks for accounts they manage. See text at notes 135-36 *infra*.

² Discretionary authority is normally obtained either through a power-of-attorney or a deed of trust. Discretionary authority may be implied, however, where an investor slavishly follows his adviser's recommendations. See SEC Advisory Comm. on Investment Management Services for Individual Investors, Small Account Investment Management Services, reprinted in CCH Fed. Sec. L. Repts. No. 465 pt. III at 19 (1973) [hereinafter cited as Advisory Comm. Report].

³ See text at notes 116-121, *infra*.

It is only recently that the phenomenon of broker-dealer entry into discretionary management has received much attention from the regulatory authorities. In the past, despite a long history of broker-dealers offering such services,⁴ discretionary management accounted for so small a portion of the business of broker-dealers that the regulators contented themselves with sanctions against fraud and trading abuses. The rapid entry of broker-dealers into investment management, however, portends changes in the law on grounds of increased need for investor protection. One can anticipate an attempt by the Securities and Exchange Commission, through reliance on the Securities Exchange Act of 1934,⁵ to upgrade broker-sponsored or broker-promoted management services by establishing standards of conduct and expanding broker-dealers' duties to customers induced to enter some form of discretionary management arrangement. Furthermore, it is entirely possible that the broker's status as agent for customers placed in discretionary management arrangements may encourage common-law courts to apply long-standing, though generally neglected, fiduciary principles in favor of dissatisfied claimants.⁶ But even beyond these kinds of developments, broker-dealer involvement in the provision of dis-

⁴ While discretionary management services have been available for many years, see Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3rd Sess., at 724-25 (1940), broker-dealers were not heavily involved in the offering of such services when professional investment advisers first became an alternative to trust companies and judicially appointed fiduciaries. See SEC, Report on Investment Trusts and Investment Companies, Supp. Report on Investment Counsel, Investment Management, Investment Supervisory, and Investment Advisory Services 11, 13 (1940) [hereinafter cited as *Investment Trust Study*]. However, events of the 1960's have made attractive to broker-dealers the prospect of supplementing cyclical brokerage income with substantial management fees, commissions resulting from transactions on discretionary accounts, and the availability of the portfolio of the accounts "to facilitate . . . other business as a broker." Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, *Securities Industry Study*, S. Doc. No. 93-13, 93d Cong., 1st Sess. 67 (1973) [hereinafter cited as *Senate Study*]. See also Subcomm. on Com. and Fin. of the Comm. on Interstate and Foreign Com., *Securities Industry Study* H.R. No. 92-1519, 92d Cong. 2d Sess. (1972) [hereinafter cited as *House Study*].

⁵ 15 U.S.C. §§ 78a-78hh-1 (1970).

⁶ Many state cases indicate that fiduciary principles are generally applicable to the broker-customer relationship. See, e.g., *Selcow v. Floersheimer*, 20 App. Div. 2d 889, 248 N.Y.S.2d 934, 935 (1964). Some cases use trust terminology. E.g., *Butcher v. Newburger*, 318 Pa. 547, 551, 179 A. 240, 241 (1935). At least one major case has dealt specifically with discretionary management. *Birch v. Arnold & Sears, Inc.*, 288 Mass. 125, 192 N.E. 591 (1934). A recent case that sent shudders through the industry before it was settled was *Trustees of Hanover College v. Donaldson, Lufkin & Jenrette, Inc.*, filed in the Southern District of Indiana December 7, 1971. Even though the portfolio of the college had risen in value, the college alleged that DLJ had selected unsuitable securities, "churned" with large and frequent transactions in order to increase profits to the manager, and collected double commissions or acted as principal for its own account, without disclosing the fact to the college. See *Belliveau*, *Discretion or Indiscretion*, *Institutional Investor*, Aug. 1972, at 65; *Gillis & Weld*, *The Money Manager as Fiduciary*, *Fin. Analysts J.*, Mar.-Apr. 1972, at 10. The latter article includes a history of the fiduciary responsibility of "money managers."

cretionary management services has grave implications with regard to the Securities Act of 1933,⁷ the Investment Advisers Act of 1940⁸ and the Investment Company Act of 1940.⁹ And, as if that were not enough, securities reform legislation pending in Congress is also likely to affect broker-dealers involved in discretionary management.¹⁰

This article will set forth some of the immediate regulatory problems now facing broker-dealers as a result of their discretionary management activities, and will speculate on some of the less certain possibilities broker-dealers may face. Thereafter, the article will present the argument that the existing situation is far too unsettled, and that if broker-dealers are to continue as competitive participants in the marketing of discretionary management services, either Congress or the SEC must develop a regulatory scheme far more coherent than present prospects.

As the reader will note, many of the problems to be discussed are not restricted to broker-dealers, but have regulatory implication for other types of investment advisers offering discretionary management services. There are two purposes in focusing on broker-dealers: (1) to avoid burdening the analysis with considerations which, though important to other types of investment advisers, do not add significantly to an understanding of how the fact of discretionary authority creates regulatory problems; and (2) because broker-dealers, for reasons which will appear presently, are likely to be the most immediate objects of the current official mood to regulate investment management services more restrictively.

I. DISCRETIONARY MANAGEMENT BY BROKER-DEALERS BEFORE 1974

A. *Regulation of Discretionary Management*

The sole federal regulation specifically pertaining to discretionary management services by broker-dealers is Rule 15c1-7,¹¹ adopted

⁷ 15 U.S.C. § 77a-77aa (1970).

⁸ 15 U.S.C. § 80b-1 to -21 (1970).

⁹ 15 U.S.C. § 80a-1 to -51 (1970).

¹⁰ Two relevant bills that failed to be enacted last year were S. 470, 93d Cong., 1st Sess. (1973) [hereinafter cited as S. 470]; H.R. 5050, 93d Cong., 1st Sess. (1973) [hereinafter cited as H.R. 5050]. In its amended form, S. 470 would have amended the securities laws to prohibit, *inter alia*, most cases of combinations of the functions of broker-dealer and money-manager by national exchange members after national exchanges begin to use negotiated commission rates in all trades. For an analysis of the bill and its purposes, see S. Rep. No. 93-187, 93d Cong., 1st Sess. (1973). For a discussion of this facet of both bills, see text at notes 130-39 *infra*. H.R. 5050 was reintroduced as H.R. 10, 94th Cong., 1st Sess. (1975), and the provisions of S. 470 were included in a new bill, S. 249, 94th Cong., 1st Sess. Both bills were pending as this article went to press.

¹¹ 17 C.F.R. § 240.15c1-7 (1974).

pursuant to Section 15(c) of the Securities Exchange Act of 1934.¹² Rule 15c1-7 is narrow in coverage, dealing only with churning and record-keeping requirements.¹³ The Investment Advisers Act of 1940, which in certain respects is more stringent about the limits of managers of discretionary accounts,¹⁴ expressly excludes from its scope any broker-dealer whose advisory activities are "solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor."¹⁵ To an extent, state securities laws¹⁶ and the rules of the national securities exchanges¹⁷ and the NASD¹⁸ provide additional restrictions on the management of discretionary accounts. But state and self-regulatory controls have been credible threats against only the most blatant misconduct.¹⁹ For the most part, regulation of discretionary man-

¹² 15 U.S.C. § 78o (1970).

¹³ Rule 15c1-7 provides:

(a) The term "manipulative, deceptive, or other fraudulent device or contrivance", as used in Section 15(c) of the act, is hereby defined to include any act of any broker or dealer designed to effect with or for any customer's account in respect to which such broker or dealer . . . is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

(b) The term "manipulative, deceptive, or other fraudulent device or contrivance", as used in section 15(c)(1) of the act, is hereby defined to include any act of any broker or dealer designed to effect with or for any customer's account in respect to which such broker or dealer . . . is vested with any discretionary power any transaction of purchase or sale unless immediately after effecting such transaction such broker or dealer makes a record of such transaction which record includes the name of such customer, the name, amount and price of the security, and the date and time when such transaction took place.

¹⁴ Section 206(3) of the Investment Advisers Act requires that an adviser acting as principal for his own account both disclose "to such client in writing before the completion of the transaction the capacity in which he is acting" and obtain the consent of the client to the transaction. 15 U.S.C. § 80b-6(3) (1970). Rule 15c1-4 requires disclosure "at or before the completion of each such transaction" but does not carry the additional requirement of prior approval. 17 C.F.R. § 240.15c1-4 (1974).

¹⁵ Investment Advisers Act of 1940, § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (1970).

¹⁶ Many state statutes dealing with fraud or the making of unreasonable predictions seem applicable to the discretionary management area. See, e.g., N.Y. Gen. Bus. L. §§ 352, 352-c (McKinney 1968), Mass. Gen. Laws Ann. ch. 110A, §§ 101-02 (Supp. 1974).

¹⁷ NYSE Rules 95, 408; AMEX Rules 410, 421.

¹⁸ NASD Rules of Fair Practice art. III, § 15, reprinted in CCH NASD Manual ¶ 2165, at 2078 (1974).

¹⁹ See, e.g., *People v. Tellier*, 7 Misc. 2d 43, 155 N.Y.S.2d 245 (Sup. Ct. 1956), where a partner of a brokerage firm was held in violation of New York law and enjoined from doing business for five years for using false and misleading statements with respect to the viability of a uranium mining company as a long term investment. Compare *Tellier* with *Herdegen v. Paine, Webber, Jackson & Curtis*, 31 Misc. 2d 104, 220 N.Y.S.2d 459 (Sup. Ct. 1961), in which the only New York statutes that might have applied to questionable advisory activities were held inapplicable to cases involving a purchaser who "does not make his purchase from the representer." *Id.* at 105, 220 N.Y.S.2d at 460. Accord, *Jones Memorial Trust v. Tsai Inv. Servs., Inc.*, 367 F. Supp. 491, 498 (S.D.N.Y. 1973). Under this reasoning, a broker-dealer with discretionary powers would seem to be safe from prosecution under New York law if he does not execute the orders himself.

agement by broker-dealers has been left to the federal authorities, and except for occasional mention in securities industry studies,²⁰ they have largely ignored the issue. Official interest has awaited the recent growth of discretionary management in importance to the brokerage industry.

B. The Entry of Broker-Dealers into Discretionary Management

As anyone familiar with the recent history of the securities markets is aware, the lucrative commission income characteristic of the brokerage business in the 1960's has evaporated. The reciprocal practices²¹ which added so much to the profitability of executing securities transactions have given way first to volume discounts and then to negotiated commissions.²² Equally painful have been the effects of the reduction in trading associated with the bear market of the last several years. Commissions are down while fixed costs, spurred by inflation, are high.

To survive the combination punch of effectively lower commission rates²³ and decreased trading volume,²⁴ a number of broker-dealers have elected to turn to the provision of discretionary management services as an additional source of business.²⁵ Many houses are creating their own affiliated management companies combining with elements of equally hard-pressed research houses or trading on

²⁰ See, e.g., SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 1, at 143-46, 152-53, 159-62 (1963) [hereinafter cited as Special Study].

²¹ See generally, *The NYSE and the Commission Rate Struggle*, 53 Calif. L. Rev. 1119, 1121-23 (1965).

²² See Note, 85 Harv. L. Rev. 794, 810-17 (1972).

²³ Although commission rates have been raised several times since the introduction, first, of volume discounts and later, negotiated commissions on large transactions, see Note, 85 Harv. L. Rev. 794, 810-17 (1972), commission rates are, as a practical matter, substantially lower. Negotiated rates have substantially reduced the return on commissions measured on a per share basis. Moreover, the introduction of negotiated transactions on large trades is really an entirely separate commission structure in which the rate is determined from trade to trade instead of according to a predetermined schedule. In either view, it is plain that commission rates have remained high only for the small investor. Even the small investor does not always pay these higher rates. Some investment advisers, not affiliated with exchange members, will bunch trades for their managed accounts in order to reach the negotiated commission plateau. They then pass these savings on to their clients.

²⁴ Trading volume figures, depressed as they are, also do not reflect accurately the change of fortune for broker-dealers. Individual investors, who account for most of the excess dollars in commissions now that negotiated commissions are in effect for large trades, have been staying out of the market. See, e.g., Welles, *The Little Man Returns Or So It Seems*, *Institutional Investor*, March 1972, at 34.

²⁵ For accounts of some of the other steps brokerage firms have taken and will be taking to improve profitability, see Bleakley, *Where Will Wall Street's Profits Come From?*, *Institutional Investor*, Sept. 1972, at 33; Carmichael, *The Securities Industry: An Audit of the Public Firms*, id. at 53.

their brokerage capabilities to offer management services as well as execution for the price of brokerage alone.²⁶

The successful marketing of advisory services can be of substantial benefit to a brokerage house in many ways. Plainly, advisory fees are a source of additional income, at least to the extent that they are not offset by the costs of managing discretionary accounts. Furthermore, so long as broker-dealers are not prohibited entirely from executing their accounts' trades through their own houses, discretionary management can provide increased trading for the brokerage side of the house.²⁷ In addition to an increase in the number of trades, and so long as some form of non-negotiated commission arrangement is permitted,²⁸ broker-dealers can still realize the benefits of large trades made in the fixed-rate era by grouping many small trades into a single large trade.²⁹ And finally, even those houses not offering discretionary management themselves or through affiliates can profit by fees received for referring accounts to those who do provide discretionary management and by acting as custodian and executing brokers for the accounts they refer.³⁰

²⁶ See text at notes 116-21 *infra*.

²⁷ There are limits to the income a broker-dealer can realize from executions for his managed accounts, however. SEC Rule 19b-2 requires exchanges to have as the "principal purpose" of their members' affiliation "the conduct of a public securities business," and non-public transactions are limited to a certain percentage of all trades. 17 C.F.R. § 240.19b-2 (1974). The rule has been criticized as inadequate by the congressional subcommittees investigating the need for securities industry reforms. See Senate Study, *supra* note 4, at 80-85; House Study, *supra* note 4, at 149-54. H.R. 5050 and S. 470, *supra* note 10, would prohibit the providing of brokerage for managed institutional accounts in transactions on an exchange. See text at notes 135-36 *infra*.

²⁸ Even when fully negotiated rates come into being, it will not follow that commissions will be negotiated for every trade. Many trades will be so small that the cost of negotiation would exceed the return from commissions. It is too early to tell whether the industry will fall into some form of parallel pricing, but it is certain that commission rates for these smaller trades will be posted rates rather than negotiated rates. Insofar as the investor subject to posted rates is concerned, the new arrangements will be little different from the arrangements during the fixed-rate regime. To the extent that price competition reduces commissions, investors will benefit. However, the rate itself will still have been imposed outside the transaction. More important, a posted rate system raises questions of fiduciary duty with regard to best execution. Broker-dealers managing discretionary accounts for individuals apparently are not going to be prohibited from executing for their managed accounts, and some houses may elect their own posted rates to subsidize their management services. See note 115, *infra*.

²⁹ See, e.g., NYSE Const. art. XV, §§ 1, 8 (the NYSE "anti-rebate" rule). By virtue of anti-rebate rules, broker-dealers can save considerable internal and other expenses by accomplishing in a reduced number of large trades the same result that would come from the effecting of many smaller ones, and at the same time charging commissions based on the theoretically smaller trades.

³⁰ Referrals are largely a phenomenon associated with the provision of discretionary management services to small investors. See Advisory Comm. Report, *supra* note 2, at 39-40. In the last two or three years, the SEC has received a number of inquiries about the legality of arrangements between broker-dealers and investment advisers. See, e.g., John C. Tead, Co., 2 CCH Mutual Funds Guide ¶ 9896, at 12559 (1973). For a discussion of some of the

II. REGULATORY PROSPECTS FOR DISCRETIONARY MANAGEMENT

A. *Securities Act of 1933*

It is possible that discretionary accounts will be regarded as securities, that broker-dealer managers of such accounts will be regarded as issuers of those securities,³¹ and that broker-dealers referring such accounts to other discretionary managers will be regarded as statutory underwriters.³² If that is so, then broker-dealers will be required to register each account being managed on a discretionary basis and every account being referred for discretionary management, or to rely on some exception or exclusion from, or safe harbor in, the Securities Act of 1933.

The route to security status for discretionary accounts is complex, but there is good reason to believe that it has been traveled almost to its destination. The starting point is *SEC v. W.J. Howey Co.*³³ In that case, the Supreme Court set out a three-pronged test for defining the term "investment contract" as that term is used in Section 2(1) of the Securities Act, the section which defines "security" for statutory purposes.³⁴ An arrangement is deemed a statutory security if it involves: (1) a contract for investing money; (2) with profits expected solely from the efforts of a promoter or a third party; and (3) a common enterprise.³⁵

Although there were indications both before and after *Howey* was decided that a discretionary account might be an investment contract and hence a security,³⁶ a strict application of the element of

implications under the federal securities laws of referral fee arrangements, see text at notes 116-30, *infra*.

³¹ A statutory issuer includes "every person who issues or proposes to issue any security." Securities Act of 1933 § 2(4), 15 U.S.C. § 77b(4) (1970).

³² A statutory underwriter is "any person who . . . offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking . . ." Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1970).

³³ 328 U.S. 293 (1946).

³⁴ 15 U.S.C. § 77b(1) (1970).

³⁵ 328 U.S. at 298-99.

³⁶ E.g., *SEC v. Wickham*, 12 F. Supp. 245 (D. Minn. 1935), where the court stated: Whether one invests money in the proverbial gold mine . . . or invests in a speculative venture by reason or the claimed skill and experience of a grain and stock market manipulator to make profits, the transactions cannot be rationally distinguished in determining the dealings which Congress intended to regulate in using the term "investment contract." Both are investments . . . Both entail the issuance of a security. In one the investor expects profits by reason of the gold to be mined; in the other, by reason of the skill and experience of the defendant in the market. In both, the opportunities for fraud are notorious.

Id. at 248-49. Following *Howey*, a number of cases came to the same conclusion. E.g., *Marshall v. Lamson Bros. & Co.*, 368 F. Supp. 486, 490 (S.D. Iowa 1974) (court stated that in the contrary line of cases the reading of the *Howey* formulation is too narrow); *Johnson v.*

the *Howey* test specifying the need for a common enterprise would seem to exclude discretionary accounts unless a number of them were being managed in common fashion. That seems to be the position the Commission and the courts had been taking as authoritative until very recently.³⁷ In fact, only three years ago, in *Milnarik v. M-S Commodities, Inc.*,³⁸ the Seventh Circuit rejected the argument that a discretionary account for trading in commodity futures is a security, on the ground that investors in these accounts "were not joint participants in the same investment enterprise."³⁹

But despite its earlier reluctance, the SEC seems now to believe, contrary to the Seventh Circuit, that strict commonality in the management of discretionary accounts is not required to create an investment contract. Although the Commission's first forays against unregistered discretionary accounts emphasized the commonality concept,⁴⁰ more recently, the Commission persuaded the Fifth Circuit, in *SEC v. Continental Commodities Corp.*,⁴¹ to hold that a discretionary commodity futures account is a security.⁴² The rationale seems to be that the reliance each investor places in the manager's acumen is a common element of the discretionary accounts sufficient to satisfy *Howey*.⁴³ Strained as this logic is,⁴⁴ it

Espey, [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,376, at 91927 (S.D.N.Y. 1972); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701, 702 (S.D.N.Y. 1968); *Maheu v. Reynolds & Co.*, 282 F. Supp. 423, 429 (S.D.N.Y. 1967). Cf. *Commercial Iron & Metal Co. v. Bache & Co.*, 478 F.2d 39, 42 (10th Cir. 1973); *Booth v. Peavey Co. Commodity Servs.*, 430 F.2d 132, 133 (8th Cir. 1970).

³⁷ Despite the well-known existence of discretionary management services, the SEC has apparently never taken action, either through enforcement or through its rule-making authority, to have discretionary accounts registered absent a common investment scheme. As recently as 1970, the Commission attacked a discretionary account arrangement as a security on grounds, among others, that investment decisions were being applied to all accounts on a uniform basis, but not simply on grounds that the accounts were being managed on a discretionary basis. See SEC Litigation Release No. 4534 (Feb. 5, 1970), discussed in text at note 60 *infra*.

³⁸ 457 F.2d 274 (7th Cir.), cert. denied, 409 U.S. 887 (1972).

³⁹ 457 F.2d at 277.

⁴⁰ See SEC Litigation Release No. 4534 (Feb. 5, 1970), discussed in text at note 60 *infra*.

⁴¹ 497 F.2d 516 (5th Cir. 1974). Accord, *Wasnowic v. Chicago Bd. of Trade*, 352 F. Supp. 1066 (M.D. Pa. 1972), *aff'd* without opinion, 491 F.2d 752 (3d Cir. 1973), cert. denied, 416 U.S. 994 (1974).

⁴² 497 F.2d at 522.

⁴³ The court discusses this principle at some length. *Id.* at 520-23. "[T]he critical inquiry is confined to whether the fortuity of the investments collectively is essentially dependent upon promoter expertise." *Id.* at 522. Guidance is "uniformly extended to all . . . investors," i.e. the same general sort of services are rendered, and "the success of the trading enterprise as a whole and customer investments individually is contingent upon the sagacious investment counseling of Continental Commodities." *Id.* at 522-23. Support for this expansive interpretation of the *Howey* "common enterprise" requirement comes from an emphasis upon the potential effect of the actions of the promoter and from focusing less on the "commonality" of the services actually provided than the type of services which the promoter contracts to provide. Otherwise, a formidable problem in analysis would arise from the fact that even

captures an idea attaining increasing support among commentators—that an arrangement or promotion should be regarded as a statutory investment contract whenever the assets at risk in an investment arrangement belong substantially to one party and the realization of a return depends primarily on the efforts of the promoter or manager.⁴⁵

This program to expand the definition of investment contract can be understood from several perspectives. From the point of view of dissatisfied investors, the Securities Act of 1933 provides a neat remedy for recovering the value of their accounts without any need to show fraud by the manager. All that is required is a showing of non-registration.⁴⁶ Moreover, the other federal securities laws, in particular the Investment Advisers Act of 1940, have a highly underdeveloped regulatory posture regarding discretionary management services. Recoveries are thus less certain, and litigation is

though the promoter extends a certain type of service to all investors, he does not perform exactly the same service and therefore does not produce identical results in every case.

⁴⁴ It should be emphasized that the discretionary accounts described in *Continental Commodities* can be distinguished from normal discretionary accounts, and that *Continental Commodities* can thus be limited on its facts. In most discretionary accounts, the investor owns the assets purchased for his account and the risk of loss is directly attributable to the wisdom of the investment decision. *Continental Commodities*, however, involved a firm placing its clients into naked options written by the firm. 497 F.2d at 518. Thus the investor's return depended on two factors:—(1) the wisdom of the investment decision; and (2) the ability of the firm to pay for the claims of its clients for successful options purchases. Once one recognizes the importance of the second element to the result, one can see that *Continental Commodities* is not quite the departure from *Howey* it appears to be because all the investors in *Continental Commodities* had in common an unstated but very real investment in the financial health of the firm. Nonetheless, even though the court seemed to appreciate the dual characteristic of the discretionary accounts at issue, it did not emphasize the common investment in the firm as a basis for concluding the accounts were securities.

⁴⁵ See Hannan & Thomas, The Importance of Economic Reality and Risk in Defining Federal Securities, 25 Hastings L.J. 219 (1974), where after a discussion of the history of the definition of securities, it is stated that "[t]he problem with the *Howey* formula is not that it is wrong, but that it is often applied restrictively and without recognizing that it is merely a statement of a result based upon the facts in the *Howey* case." Id. at 236. Emphasizing the importance of the location of the risk of loss and the control of the return on investment, Hannan & Thomas design a framework of seven questions to be answered in formulating a definition of a statutory security, and the article discusses the application of their analysis to various categories of enterprises and promotions that are currently the sources of controversy with respect to whether participations in them are statutory securities. For another example of current attitudes, see Long, An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation, 24 Okla. L. Rev. 135 (1971), in which the author describes the current law as "the result of a crazy-quilt development where the courts tended to follow the language of prior decisions without giving thought to the purpose behind the various securities acts" Id. at 139. It is suggested that a security should be defined as "the investment of money or money's worth in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture." Id. at 174 (emphasis deleted). This article is in part an attempt to improve upon another treatment in Coffey, The Economic Realities of a "Security:" Is There a More Meaningful Formula?, 18 W. Res. L. Rev. 467 (1967).

⁴⁶ Securities Act of 1933 § 12, 15 U.S.C. § 77l (1970).

likely to be more complex. But as *Continental Commodities* demonstrates, even if the remedies provided by other federal securities laws were more certain, there may be no subject matter jurisdiction under them unless the underlying agreement is determined to be a security in the first place.⁴⁷

Thus, failure to register discretionary accounts could place broker-dealers in serious jeopardy. In essence, every client owning an unregistered account would have a "put"⁴⁸ against his manager in the amount of his initial investment, regardless of how skillfully his investment program was run.⁴⁹ Furthermore, because of the structure of the Securities Act, there is little basis for obtaining substantial relief from registration by means of exemptions, exclusions and safe-harbor rules. By its terms, the statute gives the Commission very little discretion to permit registration to be bypassed.

The best routes for avoiding registration would seem to be: the intrastate exemption, section 3(a)(11);⁵⁰ the small-offering exemption, section 3(b);⁵¹ and the private offering exemption, section 4(2).⁵² But few houses would find the intrastate exemption attractive because of the severe limit on obtaining clients that this would entail. Moreover, many of the houses now expanding into money management activities already operate in more than one state. The small-offering exemption also is of limited utility since compliance with the statutory ceiling of \$500,000 virtually eliminates all institutional accounts. Even if a house were willing to restrict its discretionary management activities to accounts of \$500,000 or less,⁵³ it is

⁴⁷ All of the relevant requirements of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 apply by their terms only to transactions in or involving securities. See, e.g., the antifraud provisions of Securities Exchange Act § 10(b) which apply to the use of deception "in connection with the purchase or sale of any security . . ." 15 U.S.C. § 78j(b) (1970).

⁴⁸ Literally, a "put" is a contract which grants the holder the option to sell to the maker, at any time within a given period and at a fixed price, a certain number of shares of a stock. Puts are used by holders of stock for hedging for the duration of the contract, although they may be purchased at any time. G. Munn, *Encyclopedia of Banking & Finance* 767 (7th ed. F. Garcia rev. 1973).

⁴⁹ See text at note 46, *supra*.

⁵⁰ 15 U.S.C. § 77c(a)(11) (1970).

⁵¹ 15 U.S.C. § 77c(b) (1970).

⁵² 15 U.S.C. § 77d(2) (1970).

⁵³ Section 3(b) provides:

The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities

not at all clear that registration would not still be required. The Commission might well conclude that each separate account belongs to a set of securities so related in character that in effect the accounts should be integrated—that is, combined in value—to determine the size of the offering.⁵⁴ The practical effect of applying the integration doctrine, of course, would be to put broker-dealers to the choice of registering each account or foregoing their plans to offer discretionary management services. Finally, the private offering exemption seems an equally doubtful way out of registration. To the extent houses rely on advertising to attract clients, they will be engaging in a public offering.⁵⁵ Furthermore, even if the advertising problem could be solved, the integration doctrine would likely again come into play and keep the number of offerees so low as to eliminate discretionary management without registration.⁵⁶

It may happen, of course, that the Supreme Court or Congress will reject the Fifth Circuit's extension of *Howey* and insist on greater commonality than shared management.⁵⁷ But actually, the commonality issue is far more complex than would appear from *Milnarik* and *Continental Commodities*. Although the discussion above assumed that discretionary accounts under one house's management have little in common outside the advisory services they receive, a more realistic assumption would recognize that each account will overlap many others in portfolio composition and mix. The reasons for such overlap follow from the management approach

shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$500,000.

15 U.S.C. § 77c(6) (1970).

⁵⁴ Under the most common application of the doctrine of integration, a number of ostensibly private offerings, which are ordinarily exempt from registration under Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970), may be considered components of a single public offering in violation of the registration requirements. The integration theory has been applied to other exemptions, although it has been restricted to exemptions based on the type of offering or sale involved rather than upon the sort of securities issued. For a discussion of the doctrine, see Shapiro & Sachs, *Integration under the Securities Act: "Once An Exemption, Not Always . . ."*, 31 Md. L. Rev. 3 (1971).

⁵⁵ See SEC Rule 146, *Transactions By An Issuer Deemed Not To Involve Any Public Offering*, adopted in SEC Securities Act Release No. 5487, reprinted in 1 CCH Fed. Sec. L. Rep. ¶ 2710, at 2907-12 (Apr. 23, 1974). Reasons for the new changes appear in the release in which it was proposed. SEC Securities Act Release No. 5336, reprinted in [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79, 108, at 82395 (Nov. 28, 1972).

⁵⁶ See note 54 *supra*.

⁵⁷ There is no evidence that either is interested in doing so. Congress is currently considering major federal securities law reform without any apparent interest in questioning the jurisdictional reach of the Securities Act of 1933. See, e.g., H.R. 5050, *supra* note 10. The Supreme Court has had two recent opportunities to consider the breath of the definition of security in the Securities Act. It has declined to review each. See *Wasnowic v. Chicago Bd. of Trade*, 491 F.2d 752 (3d Cir. 1973), cert. denied, 416 U.S. 994 (1974); *SEC v. Glenn Turner Enters., Inc.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

taken by most advisers. Managers do not seek out investment opportunities⁵⁸ account by account as an individual might do with his own portfolio. For purposes of efficiency, managers evaluate investment opportunities first, and where action is indicated, identify all accounts suitable for the proposed action.⁵⁹ Although not every suitable account would be affected, it is plain that the correspondence in activity among accounts with similar objectives would be high. Moreover, the correspondence tends to increase over time because managers follow only a limited selection of investment opportunities rather than the entire investment universe. If it were otherwise, it would be virtually impossible, even with computerization, to provide clients with professional management services. Consider, for example, what would be involved in following, with sufficient depth to reach an informed investment decision, all the listed common stocks, let alone all publicly traded common stocks, debt instruments, private placements, and tax shelters—to list the investments typical of managed accounts.

Certainly, if the Commission is prepared to insist that discretionary accounts, without more, are investment contracts, com-

⁵⁸ The term "investment opportunities" is used here to include much more than opportunities to buy securities. The responsibilities of an investment adviser include decisions about buying, selling, holding, hedging, trading, choice of markets, technical conditions for investing, portfolio mix, tax consequences and so forth. Each decision is an investment decision and subject to the adviser's duty of professional care.

⁵⁹ The "suitability doctrine" is essentially a requirement that broker-dealers sell or recommend only securities that are suited to the particular investment needs of the individual customer. The doctrine arose in response to the high-pressure "boiler room" sales technique, which was designed to influence prospective investors to make on-the-spot decisions to buy instead of considering the advisability of the suggested purchases. 6 L. Loss, *Securities Regulation* 3708-09 (2d ed. Supp. 1969). Various self-regulatory measures are designed to eliminate the problem. E.g., NYSE Rule 405 (The so-called "know your customer rule"); NASD Rules of Fair Practice art. III, § 2, reprinted in CCH NASD Manual ¶ 2152, at 2051 (1974) which provides:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

Among the practices listed by the NASD Board of Governors in 1964 as a clear violation of section 2 is:

1. Recommending speculative low-priced securities to customers without knowledge of or attempt to obtain information concerning the customers' other securities holdings, their financial situation and other necessary data. The principle here is that this practice, by its very nature, involves a high probability that the recommendation will not be suitable for at least some of the persons solicited. . . .

Id. This interpretation arose in *Gerald M. Greenberg*, 40 S.E.C. 133 (1960), and is not limited in its application to the classic "boiler room." Id. at 137-38.

The SEC's suitability rule for broker-dealers who are not members of national exchanges or the NASD is Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1974), with reinforcing record-keeping requirements in Rule 15b10-6(a)(1)(ii), 17 C.F.R. § 240.15b10-6(a)(1)(ii) (1974). Commentators have discussed the requirements at length. E.g., L. Loss, *supra*, at 3708-28; Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 *Duke L.J.* 445.

monality of portfolio will only reinforce the Commission's position. Indeed, the investment community is already alerted to the grave implications of providing overlapping advisory services. Several years ago, First National City Bank and Merrill Lynch, Pierce, Fenner and Smith, Inc., jointly offered a discretionary-management program. The plan provided that investors were to be placed into one of two portfolios depending on whether the objective was income or growth. In a 1970 lawsuit the Commission took the position that the similarity of portfolios rendered each separate account a security.⁶⁰ Although the case eventually was settled, the Commission has not varied from its position. On the contrary, its view has become more expansive by focusing on substantial overlap rather than insisting on virtual identity of accounts.⁶¹ The only ameliorative step traceable to the Commission appears in the Report of the Advisory Committee on Investment Management Services for Individual Investors.⁶² The Committee concluded that, despite portfolio overlap, management highly tailored to the individual needs of an investor should be regarded as a private offering.⁶³ While this question of individualized services has not yet been resolved, present indications are that the Committee's recommendation will be rejected.⁶⁴

B. *The Investment Company Act of 1940*

The ripples from the *First National City Bank* case go beyond the Securities Act. In the complaint filed by the SEC appears the contention that Citibank was operating an unregistered investment company in addition to offering unregistered securities for sale. The argument is somewhat technical, but it follows logically from the statute. An investment company is defined in section 3(a) as "any

⁶⁰ See SEC Litigation Release No. 4534 (Feb. 6, 1970).

⁶¹ The SEC stated in *Finanswer America/Investments, Inc.*, [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,111, at 80405 (1971):

Registration of such an arrangement under the Investment Company Act would be necessary where substantially the same, or substantially overlapping, advice is rendered to each account or to a discernible group or groups of accounts, and where such accounts engage in the same securities transactions. Also, the interests offered in such an arrangement (the accounts) may be securities required to be registered

Id. at 80406.

⁶² Advisory Comm. Report, *supra* note 2.

⁶³ Id. at 23-25. The Committee's position will be difficult to sustain, in light of Rule 146. *Supra* note 56.

⁶⁴ See SEC Securities Act Release No. 5491, reprinted in [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79, 767 at 84070 (Apr. 30, 1974). This release requested public comment on the role of the Commission in dealing with bank-sponsored investment services. According to the release, discretionary accounts managed for individual investors may be regarded as securities. No mention appears of any effect individualized services might have on the status of a discretionary account as a security.

issuer which—(1) is or holds itself out as being engaged primarily . . . in the business of investing . . . in securities.”⁶⁵ An issuer is any “person who issues . . . any security.”⁶⁶ Included in the definition of person is “a company,”⁶⁷ and a company includes “any organized group of persons whether incorporated or not.”⁶⁸ Under this analysis, a set of discretionary accounts might be regarded as an organized group. Since the definition of security in both the Securities Act and the Investment Company Act is the same, such a group would be issuing investment contracts to each account owner. Thus, the group would fit the “any issuer” language of section 3(a). Finally, because the purpose of creating such account was to invest in the securities markets, the group of accounts would be an issuer engaged in investing in securities.⁶⁹

This technical argument is not without policy support since most of the dangers recited in section 1(b) of the Investment Company Act⁷⁰ which purport to justify its existence are present to a large degree when many individual discretionary accounts are under the control of one manager.⁷¹ Moreover, owners of discretionary

⁶⁵ 15 U.S.C. § 80a-3(a)(1) (1970).

⁶⁶ 15 U.S.C. § 80a-2(a)(22) (1970), which provides in full that an issuer is “every person who issues or proposes to issue any security, or has outstanding any security which it has issued.”

⁶⁷ 15 U.S.C. § 80a-2(a)(28) (1970), which defines “person” to include “a natural person or a company.”

⁶⁸ 15 U.S.C. § 80a-2(a)(8) (1970), which provides:

“Company” means a corporation, a partnership, an association, a joint-stock corporation, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.

⁶⁹ It is not necessary that the portfolio of each discretionary client consist exclusively of securities. In addition to the “engaged primarily” language of § 3(a)(1), § 3(a)(3) provides a numerical test. It includes any issuer which: “is engaged or proposed to engage in the business of investing, reinvesting, owning, holding, or trading in securities and owns or proposes to acquire investment securities, having a value exceeding 40 per centum of the value of such issuer’s total assets . . .” 15 U.S.C. § 80a-3(a)(3) (1970). In fact, there is a good argument that § 3(a)(3) would provide the jurisdictional basis for regulating discretionary management under the Investment Company Act. Since there would have been no intent to form a statutory investment company, a set of discretionary accounts, if subject to the Act, would be an “inadvertent” investment company. It has been argued that § 3(a)(3) was intended to be the jurisdictional basis for reaching inadvertent investment companies. Kerr, *The Inadvertent Investment Company*, 12 Stan. L. Rev. 29 (1960). But see *SEC v. Fifth Ave. Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968).

⁷⁰ 15 U.S.C. § 80a-1(b) (1970).

⁷¹ Like individual investors in investment companies, purchasers of discretionary management services may find that their portfolios contain over-valued securities, that their accounts have been subject to unsafe leveraging, and that their accounts have experienced questionable trading practices. As a class, individual investors are not as sophisticated about investment matters as are financial advisers to institutions such as pensions and endowments, and they do not possess the requisite financial expertise to monitor the activities of their investment advisers. See generally Advisory Comm. Report, *supra* note 2. To protect investors in investment companies from the excesses of their managers, the Investment Company Act imposes severe restrictions on the investment discretion of management. The Act requires

accounts are without even the minimal protection provided registered investment companies by outside directors. But it is plain that for all practical purposes, application of the Investment Company Act to discretionary accounts would end the service unless a large number of exemptions could be obtained. The SEC's Advisory Committee on Investment Management Services recognized the seriousness of this problem and recommended that discretionary accounts not be subjected to the Investment Company Act unless the securities nominally owned by clients were being pooled. The Committee's argument was that individual ownership of the securities in an account is so unlike the status of shareholders of traditional investment companies as to be eligible for escape from application of the statute.⁷²

That argument, although it has its appeal, is unlikely to prevail. The distinction between pooled and non-pooled accounts finds no support in the statute unless the meaning of "organized group"⁷³ is to turn on whether the securities belonging to discretionary ac-

adoption of a highly structured organizational form. See Investment Company Act §§ 14-16, 15 U.S.C. § 80a-14 to -16 (1970). The capital structure is controlled. See Investment Company Act § 18, 15 U.S.C. § 80a-18 (1970). There are various record keeping and reporting requirements. See Investment Company Act §§ 29-33, 15 U.S.C. § 80a-29 to -33 (1970). In addition, certain transactions with affiliates are prohibited absent approval of the SEC. See Investment Company Act §§ 17(a), (b), 15 U.S.C. § 80a-17(a), (b) (1970).

⁷² Advisory Comm. Report, *supra* note 2, at 22-25. Consider, for comparison, the regulatory problems associated with variable life insurance (VLI). Benefits under VLI are not fixed but are determined according to the asset value of a portfolio of securities. Although the insurance industry claimed that VLI was an insurance contract and hence should not be subject to regulation under the federal securities laws, the SEC insisted that VLI was a security and that the policyholders were investors in an investment company. Based on the SEC's previous successes in obtaining jurisdiction under the Securities and Investment Company Acts over the sale of variable annuities, see *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959); *Prudential Ins. Co. v. SEC*, 327 F.2d 383 (3d Cir. 1964), cert. denied, 377 U.S. 953 (1964), the industry capitulated. Instead it sought exemptive relief from various provisions in the federal securities laws, and especially from the Investment Company Act. After an extensive investigation, the Commission issued Investment Company Act Rule 3c-4, 17 C.F.R. § 270.3c-4 (1974), and Investment Advisers Act Rule 202-1, 17 C.F.R. § 275.202-1 (1974), which exempted VLI totally from regulation under the two statutes. See SEC Investment Company Act Release No. 7644 reprinted in [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,201 at 82654 (Jan. 31, 1973). Although the life insurance industry was poised for issuance of its new insurance vehicle, the response of many interest groups whose competitive position would be adversely affected by total exemption was outrage. Acting quickly, the SEC published proposed amendments to Rule 3c-4 and Rule 202-1, conditioning the exemptions available in those rules to a Commission determination that state insurance regulation provided VLI purchasers with protection comparable to that available under the Investment Company Act and the Investment Advisers Act. See SEC Investment Company Act Release No. 8000 reprinted in [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,518 at 83410 (Sept. 20, 1973). Since most states do not provide comparable protections, and since most state insurance commissioners were not willing to have the SEC involved in the regulation of insurance sold to their jurisdictions, VLI is not yet being actively marketed. See generally Blank, Keen, Payne, & Miller, *Variable Life Insurance and the Federal Securities Laws*, 60 Va. L. Rev. 71 (1974).

⁷³ See text at notes 65-68, *supra*.

counts are kept segregated from each other. Such an interpretation, however, would be sharply inconsistent with the commonality argument that designates discretionary accounts as investment contracts and hence statutory securities. The Commission would be hard-pressed to explain how a group of discretionary accounts are sufficiently related to be securities and at the same time sufficiently unrelated not to be members of an organized group. Furthermore, the pooling/non-pooling distinction makes little policy sense since the likelihood of the abuses which led to the passage of the Investment Company Act do not seem less likely simply because accounts are not pooled.⁷⁴

The only reasonable way out of Investment Company Act regulation, barring a large-scale discretionary exemption under section 6(c),⁷⁵ is through use of the same argument raised by the Advisory Committee against Securities Act regulation. If sufficient individualization can be achieved to transpose a group of discretionary accounts from characterization as investment contracts to classification as agency relationships, regulation under both statutes can be avoided.⁷⁶ Investors will not be acting in common, nor will they be an organized group. But again, indications are that individualization of investment services is not a touchstone the Commission will sanction, and application of the Investment Company Act to the management of discretionary accounts remains highly possible.⁷⁷

C. *The Investment Advisers Act of 1940*

Still another set of regulatory problems for broker-dealers managing discretionary accounts lies in wait in the Investment Advisers Act.⁷⁸ Originally designed as little more than a census-type licensing statute,⁷⁹ the Advisers Act promises to become a powerful regula-

⁷⁴ For example, an investment adviser willing to place an overvalued underwriting into his client's accounts will find it no more difficult to do so for a number of accounts maintained separately than he would for the same number of accounts having portfolios maintained in common. To take another example, an investment adviser anxious to stimulate referrals by broker-dealers might turn his clients' portfolios over more rapidly than otherwise. Again, it makes little difference whether custody of each account is maintained separately or in common.

⁷⁵ 15 U.S.C. § 80a-6(c) (1970).

⁷⁶ See Advisory Comm. Report, *supra* note 2, at 16-26. Actually, the Advisory Committee does not contend that the Investment Company Act and the Securities Act cannot be interpreted to apply to the management of discretionary accounts. Rather, the Advisory Committee's argument is that, as a policy matter, it would be both unnecessary and unfortunate to apply those statutes if investment advisers were providing their clients with sufficiently individualized management. *Id.* at 26.

⁷⁷ See note 64 *supra*.

⁷⁸ 15 U.S.C. § 80b-1 to -21 (1970).

⁷⁹ In 1940, David Schenker, the Chief Counsel of the SEC Investment Trust Study, described the purposes of Title II in the following terms:

Now, I cannot impress too strongly upon the Senators the fact that our title 2

tory tool for controlling the advisory activities of the professional money management community. The last decade has seen the Supreme Court breathe life into the antifraud provision of the statute by extending its scope beyond narrow common-law definitions;⁸⁰ it has seen Congress expand the statutory jurisdiction of the SEC to regulate and restrict investment management practices;⁸¹ and it has seen the SEC vastly increase its regulatory activities in administering the Act.⁸² Furthermore, the troubled condition of the securities industry is certain to reinforce congressional sentiment for creating additional regulatory controls over money management, and the most likely vehicle for legislative action is amendment of the Advisers Act.⁸³

does not attempt to say who can be an investment counselor, and does not even remotely presume to undertake to pass upon their qualifications. All we say is that in order to get some idea of who is in this business and what is his background, you cannot use the mails to perform your investment counsel business unless you are registered with us.

Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1, at 50 (1940). It should be noted, however, that the title also contains antifraud and other prohibitory provisions directed at practices of advisers. E.g. Investment Advisers Act of 1940, § 206, 15 U.S.C. § 80b-6 (1970). These received some attention in debate: "The bill makes fraudulent practices by investment advisers unlawful and requires investment advisers . . . to register with the Commission which is empowered to deny registration to individuals convicted . . . for securities frauds." 86 Cong. Rec. 9809 (remarks of Rep. Cole). Despite the presence of these sections, the statute has been administered largely as a registration measure, in contrast to the manner in which the similar provisions of the Securities Exchange Act of 1934 have been applied against broker-dealers.

⁸⁰ In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the Supreme Court held that § 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (1970), empowered the SEC to seek an injunction to compel an investment adviser to disclose the fact that he was engaging in the practice of "scalping," that is, purchasing shares of a particular security for his own account prior to making a recommendation of the same security to his clients and then selling at a profit as a result of the increase in price caused by circulation of the recommendations. In disapproving a technical construction of the statute, the Court discussed legislative history at length and concluded that the Act manifests "a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested," 375 U.S. at 191-92, and "to substitute a philosophy of disclosure for the philosophy of *caveat emptor*." *Id.* at 198.

⁸¹ Amendments to the Investment Advisers Act were passed in 1970 as a portion of Investment Company Amendments Act of 1970. 15 U.S.C. § 80b-3(d) (1970), amending 15 U.S.C. § 80b-3 (1964). These amendments extended the prohibitions of the Act to practices not involving the use of the mails or instrumentalities of interstate commerce. Other relevant amendments were accomplished in 1960. See, e.g. 15 U.S.C. § 80b-6(4) (1970), amending 15 U.S.C. § 80b-6 (1958) (adding to prohibited practices "any act, practice, or course of business which is fraudulent, deceptive, or manipulative" and directed the SEC to "define, and prescribe means reasonably designed to prevent such acts, practices, and courses of business . . .").

⁸² As a good indicator of the increase in regulatory activity, 181 Investment Advisers Act releases were issued during the period 1940-1964, while 241 additional releases were issued by the end of June, 1974. Observers fully expect SEC involvement not only to continue, but also to accelerate. See, e.g., Gillis, *Securities Law and Regulation: Regulation of Analysts*, *Fin. Analysts J.*, Jan.-Feb. 1974, at 14, 94.

⁸³ Congressman Moss, whose subcommittee produced H.R. 5050 after lengthy hearings,

Some flavor of the developments the advisory community can anticipate in connection with the Advisers Act is already evident. Fee splitting will probably be limited, if indeed it is not eliminated.⁸⁴ Financial responsibility rules will be adopted.⁸⁵ Conflicts of interest will become subject to increasing regulatory control.⁸⁶ More direct services to clients will be required.⁸⁷ Less immediate, but

see Hearings before a Subcomm. on Commerce and Finance of the Comm. on Interstate and Foreign Commerce of the House of Representatives, 92d Cong., 1st-2d Sess. (1971-72), and a study of many problems of the securities industry, see House Study, *supra* note 4, has already indicated that his next project will be an inquiry into the need for legislative changes in the Investment Advisers Act. See Wall Street Letter, Sept. 16, 1974, at 7, col. 1.

⁸⁴ Data collected in the institutional investor study confirm the importance of referrals from broker-dealers to investment advisers. See Institutional Investor Study, *supra* note 1, at 196-206. Undisclosed referrals fees are plainly unlawful. See John C. Tead, Co., CCH Mutual Funds Guide ¶ 9896, at 12559 (1973). In addition to the application of the federal securities laws to undisclosed referral fees, common-law fiduciary principles prohibit the promotion of relationships based on trust and confidence for undisclosed fees. See Restatement (Second) of Agency § 394, at 219 (1957). The question is whether fully disclosed referral fees of any type are to be permitted. See text at notes 116-30 *infra*.

⁸⁵ The Advisory Committee on Investment Management Services for Individual Investors strongly recommended minimum financial responsibility rules. See Advisory Comm. Report, *supra* note 2, at 64-66. During the recent legislative investigations into the securities industry in the House and in the Senate, a great deal of effort was expended on the question of financial responsibility requirements for broker-dealers. See House Study, *supra* note 4, chs. III-VI; Senate Study, *supra* note 4, at 23-42. Having recommended more stringent responsibility rules for broker-dealers similar congressional treatment of investment advisers cannot be far behind.

⁸⁶ Conflicts of interest are said to be "endemic to the securities business." House Study, *supra* note 4, at 149. The new regulatory mood, however, is not to abide the existence of conflicts of interest, whether perceived or real. See Senate Study, *supra* note 4, at 75-77. Whereas in the past, investment advisers were left to resolve conflicts of interest in the best fashion they could, the current sentiment seems to be to identify particular conflict-of-interest situations and to prescribe the conduct for the adviser to follow. The combination of brokerage and money management in a fixed-commission regime presents numerous opportunities for a broker-dealer manager to serve his own interests at the expense of those of his clients. See Welles, Should Money Management and Brokerage be Separated?, Institutional Investor, June 1971, at 21. Although the conflicts inherent in such arrangements have been tolerated for years, Congress is now prepared to deal with them by prohibiting broker-dealer managers from executing transactions on all securities exchanges for managed accounts. See text at notes 131-43 *infra*. Another conflict-of-interest previously ignored is the use of brokerage commissions to pay for research. The conflict arises because the manager is supposed to be earning part of his fee on the basis of his own research ability. Yet, it is obviously useful for a manager to be able to supplement his own research with that of a leading brokerage house. Proposed legislation would permit such extra-payment commissions if the manager satisfies certain statutory conditions. Senate Bill, *supra* note 10. One other example, pertaining to investment companies, is also instructive. Common-law fiduciary principles prohibit the sale of a fiduciary office lest the fiduciary's interest in his own profit influence his choice of a successor. Consonant with those principles, the case of *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971), held that the transfer for consideration of the office of investment adviser to an investment company was unlawful. *Id.* at 1342. The Senate bill sets conditions permitting such transfer on a basis, presumably, which gives the outgoing adviser adequate compensation for entrepreneurial risk without subjecting the investment company to the danger of being left with an inferior successor.

⁸⁷ As the *First National City Bank* case demonstrates, see text at note 60, *supra*, investment advisers must do more than treat all investors with comparable goals alike. See

almost as certain, entry into the profession will be restricted through the use of examinations and codes of conduct.⁸⁸ Even advisory fees are unlikely to escape official scrutiny.⁸⁹

Of course, there is nothing distinctively harsh about the treatment broker-dealers can expect from administration of the Advisers Act simply by virtue of their status as broker-dealers. All statutory investment advisers managing discretionary accounts will face essentially the same regulatory restrictions on their advisory activities whatever their organizational character. What will come as a surprise to many broker-dealers is that the Advisers Act applies to them at all, since section 202(a)(11)⁹⁰ of the Act appears to exclude them from the definition of statutory investment adviser. Section 202(a)(11) reads:

text at note 61 *supra*. There has long been an emphasis on the close personal relationship between a client and an investment manager as denoting a special type of investment management deserving of special regulatory recognition. See, e.g., Hearings on S. 3580 before a Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess., at 743-54 (1940); Hearings on H.R. 10065 before a Subcomm. of the Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess., at 86-91 (1940).

⁸⁸ A goal of the SEC is tight regulation of entry into the field, including "minimum qualification requirements and minimum financial requirements." Securities Week, Sept. 3, 1973, at 8. One member of the SEC noted the importance of such requirements, the lack of experience of many investment advisers, and the anomalous situation that arises when broker-dealers who merely execute orders must pass qualifying examinations while advisers, upon whom customers place direct reliance, need not. Hedberg, *Let's Regulate Investment Advice*, Fin. Analysts J., May-June 1973, at 24; Owens, *Investment Adviser Regulation*, Fin. Analysts J., Jan.-Feb. 1973, at 12-14. Accord, Advisory Comm. Report, *supra* note 2, at 63; Nelson, *Let's Make Investment Advisers Accountable*, Fin. Analysts J., Jan.-Feb. 1973, at 19. In addition, some states have already taken action, and others plan to do so. Oklahoma Securities Commission has issued a rule requiring that investment advisers pass the standard broker-dealer examination. Rule R-204(b)(6) reprinted in 2 CCH Blue Sky Law Rep. ¶ 39604 at 35505 (1970). Recently, in New York, there has been a strong legislative movement toward certification of securities analysts. Securities Week, Jan. 7, 1974, at 4.

⁸⁹ The first serious look at advisory fee charges came during the investigations in the 1960's into the investment company industry. During the 1967 mutual fund hearings, the SEC strongly urged that a rule of "reasonableness" be established by law as a limit on advisory fees between investment companies and their advisers. Hearings on S. 1659 before the Comm. on Banking and Currency, 90th Cong., 1st Sess. 9-24 (1967). The SEC's recommendation was not adopted, but § 36 of the Investment Company Act, the fiduciary duty section, was amended to establish by statute, that an adviser to an investment company has a fiduciary duty with respect to the receipt of compensation. Investment Company Amendments Act of 1970, Pub. L. No. 91-54 § 20, 84 Stat. 1413, amending 15 U.S.C. § 80a-36 (1970). As far as other kinds of investment advisers are concerned, the SEC maintains that an investment adviser charging an advisory fee higher than those with whom he competes must disclose to his clients ahead of time that the fee he charges is not the customary and usual fee. See, e.g., Rotan Mosle Inc., CCH Mutual Funds Guide ¶ 10,070, at 12926 (1974); Commodity Mgmt. Serv. Corp., CCH Mutual Funds Guide ¶ 10,035, at 12808 (1974). Moreover, the Investment Company Amendments Act of 1970 also introduced a new rule with respect to performance fees. *Id.*, § 25. It amended § 205 of the Investment Advisers Act, 15 U.S.C. § 80b-5 (1970), to require that performance fees adjust normal advisory fees downward to the same extent they are adjusted upward according to the performance of the client's portfolio.

⁹⁰ 15 U.S.C. § 80b-2(a)(11) (1970).

"Investment adviser" means any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities . . . but does not include . . . (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor⁹¹

To be sure, a number of broker-dealers do not rely on the statutory exclusion to avoid registration because they or their advisory affiliates charge management fees for providing investment advice and hence are probably receiving "special compensation therefor."⁹² Moreover, to an extent, the registered investment adviser credential is a public relations asset which until now has outweighed the relatively light burdens imposed by registration under the Act.

There are also many broker-dealers managing discretionary accounts who are not registered because they do not understand the limited scope of the statutory exclusion. It appears that those broker-dealers being compensated for managing discretionary accounts only by commissions generated through brokerage on clients' trades are particularly vulnerable. And broker-dealers who refer customers to affiliated or non-affiliated investment advisers in return for some form of payment from the adviser for the referral may also

⁹¹ *Id.* It seems that broker-dealers were not intended to be excluded from the definition of investment adviser as the Investment Company and Investment Advisers Acts were originally contemplated by the drafters. The proposed legislation submitted by the SEC defined "investment adviser" for purposes of both titles as follows:

"Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analysis or reports concerning securities; but does not include (a) bank; (b) any lawyer, accountant, engineer or teacher whose performance of such services is solely incidental to the practice of his profession; (c) the publisher of any bona fide newspaper or newsmagazine of general circulation; or (d) such other persons, not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

S. 3580, 76th Cong., 3d Sess. § 45(a)(16) (1940). Moreover, broker-dealers were expressly excluded from the application of Title I. *Id.*, § 3(c)(2). See also Hearings on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess. 181 (1940).

⁹² The hearings on S. 3580 show that broker-dealers receiving advisory fees were intended to be included. Hearings on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess. pt. 2, at 711 (1940). More important, the hearings on the draft of the bill which became the Investment Company and Investment Advisers Act of 1940, confirm the Committee's conviction that the exclusion in § 202(a)(11)(C), 15 U.S.C. § 80b-2a(11)(C) (1970), would not be available to broker-dealers receiving an advisory fee for their investment advisory activities. See Hearings on H.R. 10065 Before a Subcomm. on the Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 87 (1940).

be vulnerable. Such payments may be in the form of finder's fees or advisory fee splits accomplished either by lump sum payment or by payment of a regular portion of the adviser's receipts. Or the broker's reward may be less direct. The adviser may repay the favor of referrals by using the referring broker-dealer to maintain custody of advisory accounts and to execute trades for the accounts. Actually, it may not even be necessary for there to be any arrangement, formal or otherwise, between an adviser and a broker-dealer to conclude that the broker-dealer is a statutory investment adviser. It may be enough to require registration under the statute that the referring broker-dealer arrange for himself to retain custodianship and execution authority in anticipation of seeing increased turnover of the account and hence in realizing more commissions.

Section 202(a)(11)(C) sets up two conditions to be satisfied for broker-dealers to be excluded from the statutory definition of investment adviser. Furthermore, both conditions—the provision of investment advice only as an incident of the broker-dealer function and the absence of special compensation for the advice—must be satisfied for the exclusion to operate because section 202(a)(11)(C) lists them conjunctively.⁹³ Unfortunately neither condition has had an authoritative interpretation. The legislative history of section 202(a)(11)(C) is thin,⁹⁴ and there is no judicial construction on which to rely. Shortly after the Advisers Act was adopted, the SEC issued Investment Advisers Act Release Number 2, taking the position that

⁹³ Id. See text at note 91 *supra*.

⁹⁴ The meaning of the exclusionary language is unclear, since the meaning of "investment adviser" is discussed in the legislative history of the Act only in its broadest sense and by repetition of the definition provided in the Act. It is clear that the definition was meant to encompass a wider spectrum of "advisers" than members of the profession of investment counselors:

Investment advisers are persons who for compensation engage in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing or selling securities or who for compensation and as part of a regular business, promulgate analyses or reports concerning securities.

H.R. Rep. No. 2639, 76th Cong., 3d Sess. 27 (1940). Similar language appears in S. Rep. No. 1775, 76th Cong., 3d Sess. 20 (1940). David Schenker, Chief Counsel of the SEC Investment Trust Study, stated that investment advisers are "that broad category ranging from people who are engaged in the profession of furnishing disinterested, impartial advice to a certain economic stratum of our population to the other extreme, individuals engaged in running tipster organizations, or sending through the mails stock market letters." Hearings on S. 3580 Before a Subcomm. of the House Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1, at 47 (1940). Apparently, the only direct interpretation of the exclusion at issue was made by Douglas T. Johnson, Vice President of the Investment Counsel Association of America, who said that the definition would still include "certain . . . brokerage houses which maintain investment advisory departments and make charges for services rendered . . ." Id., pt. 2, at 711. Thus, the only theme that appears widely in the legislative history is that the statute is meant to apply to those who render investment advice for compensation in the ordinary course of their business or as an independent aspect thereof.

a commission surcharge based on advice to customers constitutes special compensation.⁹⁵ But that release is of little help in evaluating arrangements in which the broker-dealer is ostensibly paid only standard brokerage fees for executing transactions,⁹⁶ such as would be the case where broker-dealers offer discretionary management services for commissions, or where investment advisers offer broker-dealers some kind of emolument, such as directing brokerage business to them, for referring clients.

Despite the absence of authority, broker-dealers providing discretionary management services themselves or referring customers to investment advisers who do offer such services are taking a great risk that section 202(a)(11)(C) will be interpreted favorably to them, or at least that the sanctions of the Advisers Act will not be applied retroactively to them. If they are subsequently held to be unregistered investment advisers, their clients and customers have available the remedy of total avoidance of previous contractual arrangements,⁹⁷ much as purchasers of unregistered securities have available under the Securities Act.⁹⁸ Moreover, broker-dealers have precious little ammunition to support them in arguments that section 202(a)(11)(C) covers the discretionary management activities they now promote.

The ready impression one gains from reading section 202(a)(11)(C) is that the statute excludes only the advice and recommendations which are a normal part of a broker-dealer's attempts to stimulate use of his trading and market-making capabilities. That impression finds periodic reinforcement from several publications of the SEC. The earliest is the description in Release Number 2 of trading and market-making capabilities as the distinguishing features of a broker-dealer operation.⁹⁹ Also, the 1963 Special Study of

⁹⁵ SEC Investment Advisers Act Release No. 2 (Oct. 28, 1940).

⁹⁶ The release dealt only with the addition of an "overriding commission" or "service charge" to the regular commission which a broker-dealer would receive from executing the transaction. See *id.*

⁹⁷ Investment Advisers Act of 1940 § 215(b), 15 U.S.C. § 80b-15(b) (1970), which provides:

Every contract made in violation of any provision of this subchapter and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of this subchapter, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision.

⁹⁸ Securities Act of 1933, § 12, 15 U.S.C. § 771 (1970).

⁹⁹ SEC Investment Advisers Act Release No. 2 (Oct. 28, 1940).

the Securities Markets goes into great detail about the normal activities of broker-dealers, including their provision of investment advice, without any serious mention of discretionary management as an activity requiring further regulation or even investigation.¹⁰⁰ Finally, the Advisory Committee Report on Small Account Investment Management Services refers to broker-dealer discretionary management principally as a convenience service for investors, typically provided to customers who may be travelling or otherwise unable to supervise their accounts day-to-day.¹⁰¹

There are sound policy reasons also for insisting that discretionary management services and referrals by broker-dealers require registration under the Advisers Act. Absent registration, broker-dealers may obtain unwarranted competitive advantages over other parties marketing discretionary management services by avoiding the direct costs of registration such as fees, capitalization rules, publication requirements, periodic reporting requirements, and so forth. Equally important, without registration, broker-dealers may be able to avoid many of the indirect costs of regulation that are a necessary consequence of rules restricting advisory practices. Many of the pending developments, described above,¹⁰² so likely to become part of Advisers Act regulation, may well not become subject to parallel regulation under the Exchange Act, with the result that the burdens on broker-dealers for their discretionary advisory activities would be lighter than the burdens on registered investment advisers. Moreover, from the point of view of investor protection, it is difficult to justify less onerous regulation for broker-dealers. Questions of relative competence aside, broker-dealers are far more likely to be dealing with individual investors than other professional money managers, and the SEC has always been most concerned with the protection of individual investors.

In any event, close analysis of section 202(a)(11)(C) shows how likely it is that all broker-dealers involved in the offering of discretionary management services will be required to register under the Advisers Act. For ease of discussion, the analysis has been broken down into two sections: one dealing with broker-dealers managing discretionary accounts themselves or through affiliates; and the other dealing with broker-dealers referring customers to others for discretionary management.

1. *Discretionary Management by Broker-Dealers*

No further discussion is necessary concerning broker-dealers managing discretionary accounts for a specified fee above charges

¹⁰⁰ See Special Study, *supra* note 18, pt. 5, ch. 3, at 49-107.

¹⁰¹ See Advisory Comm. Report, *supra* note 2, at 7, 60.

¹⁰² See text at notes 84-89 *supra*.

levied for other services, such as executions, margining securities, research, custody of securities, and other kinds of services normally a part of the broker-dealer operation. Investment Advisers Act Release Number 2 establishes the SEC's position that charges levied specifically for management are a form of special compensation for advising clients about investing in securities.¹⁰³ A different problem arises when management services are offered without additional charge beyond the fees associated with the trading, custodianship, research, and other usual and customary services offered by brokerage houses. In the typical case in which no specific charge is made for discretionary management, such services are performed for commissions on executions alone.¹⁰⁴ The argument can be made that section 202(a)(11)(C) applies to broker-dealers in such cases because the broker-dealer manager is receiving no compensation, much less special compensation, for managing the account, and because the advisory services he is performing are merely incidental to the usual conduct of his business.

The argument has surface appeal. The broker-dealer manager is receiving no more for his discretionary management services than he would if he were merely handling the account in the customary non-discretionary way. That is, instead of contacting his clients before every transaction, he has the authority to make investment decisions without consultation. But except for that aspect of his responsibilities, he treats his discretionary accounts no differently from the way he treats his non-discretionary accounts. He obtains the same quality of execution for each; he provides the same quality of custodianship; and the research on which he bases his recommendations to his non-discretionary clients is the same as the research on which he bases his investment decisions for his discretionary accounts. Furthermore, since execution capability, custodianship, and research, the major components of broker-dealer managed discretionary accounts, are historically the identifying features of successful brokerage houses, it would seem reasonable to regard the additional factor of discretionary authority as merely incidental to the brokerage business.

There are two essential faults with this logic. The first is the assumption that because the charges assessed against discretionary and non-discretionary customers are the same, the broker-dealer is

¹⁰³ SEC Investment Advisers Act Release No. 2 (Oct. 28, 1940). See text at notes 92-95 *supra*.

¹⁰⁴ For a description of some of the operations of firms offering management for commissions, see Andrews, Sanford Bernstein: What Makes Sandy Run?, *Institutional Investor*, Sept. 1972, at 61; Andrews, Money Managers Discover the Little Guy, *Signature*, Oct. 1972, at 1.

not being compensated specially for his advisory activities. The fallacy lies in ascribing accuracy to the broker-dealer's description of the purposes for which his charges are made. Although he may bill discretionary and non-discretionary customers alike, it is a different package of services he is providing to each. The brokerage industry has historically used fixed fees for particular services, principally commissions for trading services, to underwrite the costs of providing its customers other types of services. It is no different where discretionary management services are concerned. Discretionary management in exchange for brokerage fees is not a "free" service. From the broker-dealer's point of view, his receipts are directly related to the number and frequency of trades in securities he executes. The anti-churning rules make it unlawful for broker-dealers to increase the frequency of the trades they execute in order to increase their commissions. As a consequence, broker-dealers can increase their receipts only by offering additional services to attract accounts. Seen in this light, the offering of advisory services for commissions alone actually represents broker-dealers' underwriting with commission dollars the costs of providing discretionary management. The commissions an investor pays cover a combination of services: (1) executions; and (2) discretionary management. At least when investors establish brokerage accounts principally for discretionary management service rather than execution service, it is reasonable to describe the broker-dealer's receipts as special compensation "as to the advisability of investing in, purchasing, or selling securities" within the language of section 202(a)(11)(C).¹⁰⁵

The second fault is the failure to recognize how significant an impact executions for discretionary accounts can have on a broker-dealer's profit margin. Discretionary management is not simply another service, like research or custodianship, with which a broker-dealer can attract more customers. Discretionary management means much more efficient use of a broker-dealer's research capabilities for his accounts and large economies of scale in executing transactions for his customers.

The increased efficiency and the use of the broker-dealer's research services comes about through his complete authority to determine when his own research should be acted upon. For non-discretionary accounts, the broker-dealer must contact suitable customers and persuade them of the merit of his work. Many such customers do not avail themselves of the benefits of his research, and those who do make up their minds at different times. Furthermore, non-discretionary customers frequently desire research assis-

¹⁰⁵ 15 U.S.C. § 80b-2(a)(11)(C) (1970).

tance on matters not of major interest to the broker-dealer, a service which adds substantially to the broker-dealer's expenses. The burdens of providing research services to discretionary accounts are quite different. Not only does the broker-dealer evaluate his research for the benefit of all suitable accounts at once, he can also make the investment decision for all suitable accounts at the same time. Moreover, it is relatively cheap for him to screen his discretionary accounts to find out which clients should act on his investment plans based on his research. He does not need to call large numbers of customers who live and work in different places, and who have different attitudes and habits, and who may want different or additional information. On the contrary, he identifies the appropriate clients from information he has in his own files.

Even more valuable than the reduction in cost in identifying the proper research for the proper customers is the pecuniary advantage realized from executing all trades for discretionary accounts at the same time. The stock exchange anti-rebate rules require the broker-dealer to charge each client a commission exactly the same as if the order had been executed for each account separately.¹⁰⁶ But a combined order is not nearly as expensive to execute as it would be if it had been executed separately for each account. As a consequence, the broker-dealer can realize substantial profits similar to those available when institutional trading was also done on a fixed-commission basis. It is this surplusage which easily fits the definition of special compensation required by the statute.¹⁰⁷

A technical analysis of section 202(a)(11)(C) also shows that discretionary management was not recognized by the drafters of the statute to be incidental to normal brokerage activity. "Broker" is

¹⁰⁶ E.g., NYSE Const. art. XV, § 2(a), which applies the commission rate schedule for non-members to "that portion of any order involving an amount of \$300,000 or less, or business for non-members and allied members, including joint account transactions in which any such person is interested" NYSE Const. art. XV, § 1 provides:

[Commissions] shall be charged and collected upon the execution of all orders for the purchase or sale for the account of . . . parties not members or allied members of the Exchange . . . and these commissions shall be at rates not less than the rates in this Article prescribed; and shall be net and free from any rebate, return, discount or allowance made in any shape and manner, or by any method or arrangement direct or indirect. . . .

¹⁰⁷ It may seem anomalous to condition registration of a broker-dealer on whether he lumps trades or executes them separately by focusing on the additional profits a broker-dealer receives through lumping as special compensation. But § 202(a)(11)(C), 15 U.S.C. § 80b-2(a)(11)(C) (1970), is responsible for that consequence by focusing on the extent of compensation rather than the character of a broker-dealer's advisory activities as the determinant of whether the statute requires registration as an investment adviser. In a world which regulated members of the securities industry alike on the basis of their activities, true brokerage business would not need an exemption from the Investment Advisers Act and all advisory business would look to a common source of regulation. This issue is discussed more fully in the conclusion. See text at notes 182-83 *infra*.

defined in section 202(a)(3) as "any person engaged in the business of effecting transactions in securities for the account of others" ¹⁰⁸ "Dealer" is defined in section 202(a)(7) as "any person regularly engaged in the business of buying and selling securities for his own account" ¹⁰⁹ Neither of these definitions implies the provision of discretionary management services as part of the ordinary business of a broker-dealer. It is particularly difficult to characterize broker-dealers who manage a substantial number of discretionary accounts as providing services incidental to their brokerage business. Historical arguments about the structure of the industry at the time the statute was drafted aside, ¹¹⁰ broker-dealers who offer discretionary-account advisory services are competing with investment advisers for advisory business far more than with other broker-dealers for brokerage business, since the attraction to investors is the advisory service. Discretionary management for commissions alone in effect undercuts competing investment advisers in the amount of the non-broker-dealer adviser's advisory fee. Had Congress wished to exclude broker-dealers from Adviser Act regulation of their advisory activities simply by virtue of their status as broker-dealers, it surely would have done so in the same explicit language with which it excluded banks. ¹¹¹

Even if discretionary management services offered for commissions alone could somehow fall within the section 202(a)(11)(C) exclusion, such arrangements will be virtually impossible to maintain once fully negotiated commissions are introduced. Discretionary managers are under a fiduciary duty to seek best execution on trades for their clients. ¹¹² Best execution has been interpreted to mean best price, ¹¹³ although there is a substantial body of opinion that an adviser may pay commissions above best price in return for research for the accounts he manages. ¹¹⁴ But if an adviser pays a commission

¹⁰⁸ 15 U.S.C. § 80b-2(a)(3) (1970).

¹⁰⁹ 15 U.S.C. § 80b-2(a)(7) (1970).

¹¹⁰ See text at notes 99-101 *supra*.

¹¹¹ Section 202(a)(11) provides: " 'Investment adviser' . . . does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 which is not an investment company. . . ." 15 U.S.C. § 80b-2(a)(11) (1970).

¹¹² See, e.g., Delaware Mgmt. Co., SEC Securities Exchange Act Release No. 8128, reprinted in [1966-67 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,458, at 82883 (July 19, 1967). Sacrificing best execution to serve the adviser's interest is not merely a breach of fiduciary duty. It is also violative of the federal securities antifraud rules. See, e.g., Continental Inv. Corp., SEC Securities Exchange Act Release No. 11072 (Oct. 24, 1974).

¹¹³ See, e.g., Kidder, Peabody & Co., SEC Securities Exchange Act Release No. 8426, reprinted in [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,618, at 83321 (Oct. 16, 1968).

¹¹⁴ The SEC has been in the forefront of the movement to relax fiduciary obligations in brokerage transactions. In SEC, Policy Statement on the Future Structure of the Securities Markets, reprinted in [Special Studies Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 74,811, at 65611 (Feb. 2, 1972), the Commission expressly took the position that advisers could pay

above the best price, he is paying special compensation for the research. It is not payment merely for execution, since by hypothesis he is paying for more than the cost of execution. Should this payment go to himself for his own research services, a broker-dealer would be receiving special compensation for advising his clients. Moreover, this kind of arrangement would place an intolerable strain on the relationship between the broker-dealer manager and his client. The manager would be left to decide not whether someone else's recommendations were good enough to justify payment of extra commission dollars for them, but whether his own recommendations warranted such additional compensation. It is difficult to see how fiduciary principles could be construed to permit this.¹¹⁵

2. Referrals

Not all broker-dealers have found it worthwhile to tap investor interest in professional money management by offering discretionary advisory services directly. Some have seen profit in referring their customers to investment advisers in exchange for some form of compensation for the referral. The SEC staff has taken a rather

commissions in excess of best price in exchange for services valuable to the client. *Id.* at 65620. Shortly thereafter, the Commission formally adopted the position taken in the Policy Statement. See SEC Securities Exchange Act Release No. 9598, reprinted in [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,776, at 81631 (May 9, 1972). Securities legislation now pending in Congress expressly authorizes investment advisers to pay higher commissions in exchange for research services. See note 86 *supra*. Despite these inroads into the fiduciary duty of obtaining best price execution, it remains unclear whether these federal developments can preempt state law on this issue.

¹¹⁵ Under principles of agency, for example, an agent "is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency." Restatement (Second) of Agency § 387, at 201 (1958). This is the "duty of loyalty," violation of which could not be more effectively encouraged than by placing the agent in a position to evaluate the quality of his own services and charge his principal accordingly.

The problem of a broker-dealer's paying higher commissions for his own research should be distinguished from the problem of negotiating best-price commissions with himself. Unlike the subjective valuation involved in assessing research, a broker-dealer has a reasonably objective standard for determining what the cost to his client should be for buying and selling securities since other houses will be setting prices which can be compared with those of the managing broker-dealer. For more extensive discussion of this point, see text at notes 146-47 *infra*.

This conflict between the broker-dealers' trading activities and their fiduciary obligations when acting as investment advisers became clear as a result of the passage of the Employee Retirement Income Security Act of 1974 (The Pension Reform Act) Pub. L. 93-406, 88 Stat. 829 (1974) (codified at 29 U.S.C. §§ 1001-1381). The law imposes specific standards of conduct on "fiduciaries" connected with pension plans, prohibiting them from dealing with plan assets for their own account or from personally benefiting from transactions involving those assets. *Id.* Part 4, § 406. The provision would thus bar broker-dealers from handling securities transactions for plans for which they serve as advisers. In response to industry protest, broker-dealers were granted an exemption so that they could continue to provide research services to plans as long as they did not charge separately for such advice. See *The Wall Street Journal*, Feb. 14, 1975, at p. 28, col. 1.

jaundiced view of referral fees, however, and it has denied no-action letter requests involving such arrangements between broker-dealers and investment advisers, even in the face of full disclosure to the investor.¹¹⁶ The staff's position, apparently, is that regularized fee sharing through receipt of a portion of the advisory fee or through reciprocal brokerage creates conflicts of interest so fundamental as to render the relationship inherently fraudulent or deceptive. On the other hand, the staff also seems to feel that associations between investment advisers and broker-dealers are permissible. At least if the broker-dealer receives only the ordinary brokerage associated with executing the trades recommended by the adviser, the customer has the option to choose a different broker-dealer, and there is full disclosure of the relationship.¹¹⁷

The staff's position was severely criticized at the PLI Fourth Annual Institute on Securities Regulation.¹¹⁸ In addition, the Advisory Committee on Investment Management Services for Individual Investors sharply disagreed with the staff's conclusion that fee sharing arrangements, when fully disclosed, could be fraudulent or deceptive.¹¹⁹ The Advisory Committee did feel, however, that continuous fee sharing does put excessive strain on the fiduciary relationships between the broker-dealer, the investment adviser and the investor.¹²⁰ The Advisory Committee recommended that a one-time finder's fee, reasonable in amount and fully disclosed, be permitted referring broker-dealers.¹²¹ Neither the Commission nor the staff has indicated whether the Advisory Committee's recommendation is acceptable.

Perhaps because it is a relatively new regulatory issue, the SEC has dealt with fee sharing arrangements rather insensitively. Broker-dealers by trade are well suited to perform the "hand-holding" function¹²² that clients of discretionary managers seem so

¹¹⁶ See, e.g., John C. Tead Co., CCH Mutual Funds Guide ¶ 9896, at 12559 (1973); Argus Sec. Mgmt. Corp., [1971-72 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78366, at 80833 (1971); Reinholdt & Gardner, [1969-73 Transfer Binder] CCH Mutual Funds Guide ¶ 9213, at 11472 (1971).

¹¹⁷ See Hartzmark & Co., CCH Mutual Funds Guide ¶ 9900, at 12563 (1973); Thomas L. Gordon, CCH Mutual Funds Guide ¶ 9831, at 12434 (1973); Bacon, Whipple & Co., [1969-73 Transfer Binder] CCH Mutual Funds Guide ¶ 9673, at 12308 (1972). Cf. John G. Kinnard & Co., CCH Mutual Funds Guide ¶ 9941, at 12631 (1973).

¹¹⁸ S. Friedman, Problems Involving Investment Advisers and Broker-Dealers Serving Individual Accounts, in Fourth Annual Institute on Securities Regulation 295, 297-308 (PLI Transcript Series) (1973).

¹¹⁹ Advisory Comm. Report, *supra* note 2, at 41.

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² "Hand-holding" is the term used by the advisory community to describe a close and continuous relationship between a discretionary account manager and the account owner.

much to need, and that some investment advisers seem so reluctant to give.¹²³ Also, referral fees can be a form of compensation to broker-dealers for evaluating various investment advisers for the customers they are referring. To a certain extent, referral fees in this context serve the purpose the commissions broker-dealers receive for selling sales-load mutual funds were supposed to serve but never did.¹²⁴ At the PLI Conference, Commissioner Pollock indicated that the major concern of the SEC is that referral fees will become marketing devices for investment advisory services.¹²⁵ But even if referral fees were only compensation for marketing services, that is precisely the function a middleman is supposed to serve. It is elementary that absent collusive agreements or government-enforced restrictions on competition, where there is full and fair disclosure, a middleman reduces the cost of the final product to a consumer and improves its quality to boot.¹²⁶ Instead, the concern of the SEC should be that the information customers of broker-dealers receive be sufficient to permit intelligent investor choices about the advisory services recommended to them. If that is the case, the referral fees

¹²³ Hand-holding has a pejorative connotation because some account managers view contacts with the client as burdensome and inefficient. Client contact is said to take up a great deal of time which could be better spent analyzing investment opportunities. See Advisory Comm. Report, *supra* note 2, at 30; Andrews, *Money Managers Discover the Little Guy*, Signature, Oct. 1972, at 1.

¹²⁴ Like individual investment advisers, the product of mutual funds is professional investment management for which the client of an investment adviser and the shareholder in a mutual fund pay an advisory fee. Brokers do not sell no-load mutual funds because the sales load represents the underwriting commission, nearly all of which goes to the selling broker. The sales load is supposed to be the only compensation received by the broker. In theory, this commission compensates a broker for identifying the best-managed funds having the investment goals of the investor. Most will concede, however, that brokers performed this function poorly, if at all. In the heyday of mutual fund growth, the major interest of brokers in selling mutual funds shares was the receipt of reciprocal brokerage from the fund for selling its shares, a fact which was never disclosed to sales-load mutual fund purchasers. The courts and the Commission have since made it fairly plain that reciprocity for selling fund shares is unlawful. See, e.g., *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971); SEC Securities Exchange Act Release No. 10,439 (Oct. 19, 1973) (adoption of Rule 15b10-10). But even now, there is little incentive for broker-dealers to perform any substantial evaluative and monitoring function for customers they place in mutual funds. There still is no requirement for them to disclose that other mutual funds can be purchased for different underwriting commissions and that no-load mutual funds can be purchased for no underwriting commission at all. Thus, they still view the load only as compensation for servicing the fund because they do not have to justify their commissions to their customers as compensation for aid in finding a suitable well-managed fund, and for assistance in watching the management of the fund.

¹²⁵ Fourth Annual Institute on Securities Regulation 305-07 (PLI Transcript Series) (1973).

¹²⁶ See, e.g., A. Alchian & W. Allen, *University Economics* 35-46 (3d ed. 1972). There is evidence that investors already recognize the value of having independent experts assess the work of professional money managers. A number of firms whose principle line of business consists of evaluating performance and management services have come into being. Cf. Levy, *How to Measure Research Performance*, 1 J. of Portfolio Mgmt., Fall 1974, at 44. Broker-dealers are in an excellent position to provide this kind of service, especially to individual investors.

broker-dealers receive will be accurate reflections of the services they are providing investors, not hidden profits obtained by overcharging investors for assistance of doubtful value.

There is a more important consideration in favor of permitting fully disclosed fee sharing arrangements between broker-dealers and investment advisers. Broker-dealers who receive compensation in any form for making referrals are not mere middlemen without any initial or continuing obligation to their clients. By virtue of the consideration they receive for making referrals, they should be held to be statutory investment advisers, and thus subject to the regulatory restrictions against self-dealing imposed by the Advisers Act. Thus, in addition to the regulatory protection of the Advisers Act provided investors with respect to their portfolio managers, investors will benefit by having another financially responsible party to answer for the breaches of duty of the adviser, at least if the referring broker-dealer was or should have been aware of the adviser's breach of duty. This factor not only enhances investor protection in cases of actual wrongdoing, but also encourages broker-dealers to watch over advisers to prevent wrongdoing.

The application of the Advisers Act to referring broker-dealers can be explained in two ways. Under standard common-law analysis, participation in the advisory fee, which is the consideration paid by the investor for advisory services, makes the broker-dealer responsible along with the investment adviser for the performance of the obligations of the advisory contract.¹²⁷ Under analysis of the

¹²⁷ There are several theories under which a continuing duty to monitor and evaluate the adviser might be imposed on the broker-dealer. The adviser and broker-dealer might be regarded as joint venturers in managing the client's account, the adviser assuming principal responsibility for investment decisions and the broker-dealer assuming principal responsibility for executions and custody of the portfolio. Or, by virtue of the broker-dealer's power to promote an advisory relationship between the client and adviser, the broker-dealer might be regarded as the agent and the adviser as a sub-agent of the client.

[An agent is liable to his principal] if, having a duty to appoint or to supervise other agents, he has violated his duty through lack of care or otherwise in the appointment or supervision, and harm therefore results to the principal in a foreseeable manner.

He is also subject to liability if he . . . permits, or otherwise takes part in the improper conduct of other agents.

Restatement (Second) of Agency § 405(2), at 251 (1958). The critical elements of these and other common-law theories of recovery are the position the broker-dealer occupies with respect to selection of an adviser and the compensation the broker-dealer receives for his efforts. To the extent a broker-dealer aids an investor in selecting an adviser, the broker-dealer represents that he has the professional ability to choose an adviser offering competent advisory services. He owes the client a duty of ordinary skill and care in executing this responsibility. Moreover, the referral fee is consideration for assuming that duty. If the broker-dealer also receives continuing compensation during the life of the advisory agreement, the only reasonable explanation for such compensation is that it is in exchange for the assumption of continuing duties with respect to the account. Any other interpretation would allow the broker-dealer the right to profit on a regular basis from the advisory relationship without any corresponding duty to the client.

Advisers Act, the broker-dealer's receipt of compensation for promoting the creation of a discretionary account makes him a statutory investment adviser.¹²⁸ Once again, the explanation lies in the expansion of the meaning of investment contract, since the *Howey* decision, to include discretionary accounts.¹²⁹

The definition of security is as broad in the Advisers Act as it is in the Securities Act, and there is no reason to believe that it will be given any different scope. As a result, any referral made by a broker-dealer for the purpose of promoting a discretionary management relationship makes the broker-dealer an "investment adviser" under the Advisers Act: a "person who, for compensation, engages in the business of advising others . . . as to the advisability of investing in, purchasing, or selling securities . . ."¹³⁰ Moreover, the exclusion of section 202(a)(11)(C) is of no value since the broker-dealer would be receiving special compensation. Even in situations in which the broker-dealer is not compensated directly for the referral, he would have to rely for exclusion from registration on having his referral regarded as solely incidental to his broker-dealer activity. Certainly the SEC is not likely to sympathize with such an interpretation, and given the absence of any established practice on the part of broker-dealers to act as intermediaries in bringing investors and advisers together, it is difficult to imagine the courts reacting any differently.

D. Brokerage for Managed Accounts

One of the more remarkable regulatory controversies of the last several years has been the issue of whether broker-dealers should execute trades for their own managed accounts. Two years ago, the SEC adopted Rule 19b-2¹³¹ pursuant to section 19(b) of the Securities Exchange Act.¹³² Rule 19b-2 does not prohibit broker-dealers from executing trades for their managed accounts, but it requires a broker-dealer to execute at least 80% of its business on an exchange with non-affiliated persons.¹³³ "Affiliates" are defined as persons in

¹²⁸ See Dillon, Read & Co., CCH Mutual Funds Guide ¶ 9903, at 12573 (1973) (broker-dealer splitting advisory fees with operator of information retrieval system is investment adviser to clients of operator).

¹²⁹ See text at notes 31-64 *supra*.

¹³⁰ Investment Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (1970). The SEC recently took this position, in FPC Securities Corp., CCH Fed. Sec. L. Rep. ¶ 80,072, at 85008 (Sept. 9, 1974). See also note 91 *supra*.

¹³¹ 17 C.F.R. § 240.19b-2 (1974).

¹³² 15 U.S.C. § 780 (1970).

¹³³ Rule 19b-2 provides:

(a) [A] member [of an exchange] shall be deemed to have such a purpose [the conduct of a public securities business] if at least 80 percent of the value of exchange securities transactions effected by it during the preceding 6 calendar months, whether as a broker or dealer, is effected for or with persons other than affiliated persons

a control relationship with the broker-dealer, principals of the broker-dealer, and investment companies for which the firm acts as adviser or has a control relationship with the adviser.¹³⁴ It now seems that Rule 19b-2 was only the beginning. Five months after the adoption of Rule 19b-2, the Senate passed S. 470 which, among other things, prohibits broker-dealers from executing transactions on an exchange for themselves, their affiliates, and all managed institutional accounts.¹³⁵ In effect, only the managed accounts of individual investors are left untouched. Pending in the House is H.R. 10, which, as currently drafted, would also prohibit broker-dealers from executing transactions on an exchange for themselves, their affiliates and all discretionary or non-discretionary advisory clients of a firm other than individuals.¹³⁶

The justification for separating brokerage from money management is that such a restriction eliminates serious conflicts-of-interest.¹³⁷ If brokers may trade for the accounts they manage, the results, it is feared, will be churning,¹³⁸ sacrifice of best execution,¹³⁹ dumping,¹⁴⁰ and scalping either for the benefit of the broker-dealer manager himself or for the benefit of one class of his customers over another.¹⁴¹ But insofar as institutional investors are

17 C.F.R. § 240.19b-2 (1974). To assist market liquidity, the rule contains eight exceptions for purposes of calculating transactions with affiliates. See *id.*

¹³⁴ Rule 19b-2(b) defines affiliated person as one controlling, controlled by, or in common control with, a member; or as a principal officer, stockholder, or partner of a member; as an investment company advised by a member of any person controlling, controlled by, or under common control with a member. 17 C.F.R. § 240.19b-2 (1974).

¹³⁵ S. 470, 93d Cong., 1st Sess., § 2 (1973), reintroduced as part of S. 249, 94th Cong., 1st Sess. (1975).

¹³⁶ H.R. 10, 94th Cong., 1st Sess. 1975.

¹³⁷ Senate Study, *supra* note 4, at 75-77.

¹³⁸ Churning is the excessive turnover of an account. While churning is easier to do with discretionary accounts than with non-discretionary accounts, a broker-dealer who induces clients to buy and sell securities for no real purpose beyond producing commission income is guilty of churning. See Special Study, *supra* note 20 pt. 1, at 271.

¹³⁹ "Best execution" is not given to precise definition. While it generally refers to executions producing the best price for the client, see text at notes 112-13 *supra*, where price is not different among traders, best execution includes the obligation to select traders who will carry out the transaction most efficiently and are most likely to deliver according to the terms of the purchase or sale. There is also a large body of opinion that an adviser may sacrifice best price execution to purchase research or other services with the extra commission dollars generated in a trade without sacrificing best execution. See text at notes 114-15 *supra*.

¹⁴⁰ "Dumping" is the term used to describe the placement of over-valued stock owned by the adviser or by one of his more favored accounts into one or more of his less favored accounts. Dumping was a particularly severe abuse of investment company managers prior to passage of the Investment Company Act. See Investment Trust Study, *supra* note 4, pt. 3, at 2581. Now there is concern that investment advisers will use their discretionary accounts as receptacles for difficult-to-position block trades. Senate Study, *supra* note 4, at 76.

¹⁴¹ "Scalping" describes the purchase or sale of securities by an investment adviser in advance of substantial purchases or sales by his clients. In this fashion, he hopes to profit by the price rises associated with the purchases he makes for his other clients and to sell for a higher price by avoiding the downward pressure on the market that may result from sales by

concerned, the evidence that conflicts-of-interest associated with combined brokerage and management are real and serious is at best scanty.¹⁴² Certainly, the congressional reports recommending separation of brokerage and management offered little to support their position.¹⁴³ The more probable explanation is a political one. In-

his clients. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), *supra* note 80.

¹⁴² Since 1958, there have been a variety of official inquiries of greater or lesser depth into the advisory activities of broker-dealers. The Wharton Study of Mutual Funds found a mild indication that portfolio turnover was higher for mutual funds affiliated with brokers, although the largest funds apparently experienced lower turnover than average. SEC, *A Study of Mutual Funds* 224-26 (1962). The Report also speculated that the high concentration of executions with broker-affiliates, *id.* at 473-75, indicated that such mutual funds may have been sacrificing certain service benefits that may have been obtained by executing elsewhere. *Id.* at 32. The Special Study of the Securities Markets found ample evidence of churning, dumping, sacrifice of best execution, and preferential treatment of customers, but made no distinction between managed and non-managed accounts. Special Study, *supra* note 18, at 297-98, 371-74, 958-59. The SEC Report on Investment Company Growth found, contrary to the Wharton Report, that median turnover rates for broker-affiliated investment companies were below industry averages. SEC, *Report on the Public Policy Implications of Investment Company Growth*, H. Rep. No. 2337, 89th Cong., 2d Sess. 189 (1966). The SEC speculated without evidence that broker affiliation might lead to sacrifice of best execution, but specifically declined to recommend legislation limiting such affiliations if commission income were a factor in setting advisory fees. *Id.* at 190.

Next came extensive legislative efforts leading to the 1970 amendments to the Investment Company Act. See S. Rep. No. 91-184, 91st Cong., 1st Sess. (1969); H.R. Rep. Nos. 91-1382, 91-1631, 91st Cong., 2d Sess. (1970); Hearings on S. 34 & S. 296 Before the Senate Banking and Currency Comm., 91st Cong., 1st Sess. (1969); Hearings on S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. (1967); Hearings on H.R. 11995, H.R. 13754, H.R. 14737, Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess. (1969).

The Investment Company Amendments Act of 1970 became law on December 14, 1970. Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413. Throughout this period, there was no sentiment to change § 17(e) of the Act, 80 U.S.C. § 80a-17(e) (1970), which permits broker-affiliates of investment companies to receive normal commissions on executions for such companies. In 1971, the SEC focused specifically on the reasons for institutional affiliations with broker-dealers. It found three reasons for such affiliations: (1) reduction of brokerage costs to managed accounts; (2) diversification of business activities; and (3) desire for distribution facilities. Institutional Investor Study, *supra* note 1, pt. 4, at 2296. The results of regression analysis of the collected data show a mildly higher turnover for affiliated accounts, *id.*, pt. 2, at 173, 363, but lower advisory fees for affiliated accounts. *Id.*, pt. 2, at 213. The only conflict-of-interest identified as serious was the preferential treatment of certain accounts, although even here the data suggested that managed accounts were beneficiaries rather than victims. *Id.*, pt. 2 at 372-74. Indeed, the letter of transmittal accompanying the Study explicitly asserted the Study had found no demonstrated need for separating brokerage and management. *Id.*, summary vol., at xx.

¹⁴³ The section of the House Report dealing with the conflicts of interest involved in combining brokerage and management, House Study, *supra* note 4, at 148-53, should be a source of professional embarrassment to those who drafted it. Justification for the Subcommittee's position is contained in seven footnotes. See *id.* at 148-49, nn.4-10. These citations are to treatises, articles and to cases at most only modestly helpful. There is nothing empirical except the information incorporated from findings in parts of the Special Study, *supra* note 18. House Study, *supra* note 4, *id.* at 148-49 nn.4 & 5. The House Report did not even refer to testimony in its own subcommittee's hearings which tended to substantiate, though not establish, some need for separation of brokerage and management. See, e.g., Hearings on the Study of the Securities Industry before the Subcomm. on Commerce and Finance of the Comm. on

stitutional investment advisers lacking execution capability were able to promote the conflict-of-interest issue into congressional endorsement of their desire to eliminate the capability of broker-dealers to execute for their managed accounts because of the competitive advantage involved.¹⁴⁴

Interstate and Foreign Commerce, 92d Cong., 2d Sess., Ser. No. 92-37h, pt. 9, at 4271-72, 4274 (1972) (churning); *id.* at 4281 (dumping). The Senate Report at least referred to some credible evidence of dumping by block positioners into managed accounts, Senate Study, *supra* note 4, at 76, but it relied primarily on testimony about the potential for abuse to substantiate the need for adopting a rule to deal with the abuse. *Id.* at 75-77 nn.68-75.

¹⁴⁴ When declining commission profits attributable to volume discounts, negotiated commissions and declining markets led to increasing broker-dealer entry into institutional investment management, other professional investment managers began to find themselves in an unfortunate position. The stock-exchange anti-rebate rules prevented them from recovering commissions for the benefit of their clients, and hence deprived their clients of effectively reduced advisory fees. Broker-dealers, on the other hand, knew that they would profit from commissions and were able to set lower advisory fees than their non-member competitor advisers. Non-member advisers reacted strongly to this phenomenon principally by seeking membership on stock exchanges to recapture commissions. NYSE members predictably responded by attempting to bar institutional advisers, the broker-dealers' most important potential competitors for brokerage business, from membership by restricting membership to organizations doing primarily a public business. See NYSE Rule 318.12. But faced with an antitrust challenge to their position by one of the country's largest institutional investors, see Hearings on the Study of the Securities Industry Before the Subcomm. on Commerce and Finance of the Comm. on Interstate and Foreign Commerce, 92d Cong., 2d Sess., Ser. No. 92-37g, pt. 8, at 4122-31 (1972), the NYSE, supported both by members offering management services and those not offering such services but fearful of losing institutional commission income, and armed with a special report written by William McChesney Martin, raced to Washington to enlist the SEC in protecting their interests by barring institutions from direct access to the exchanges. See W.M. Martin, *The Securities Markets: A Report with Recommendations*, reprinted in [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,184, at 78183 (1971). The result was Rule 19b-2, which went beyond even the NYSE limitations on access to membership for firms affiliated with institutions. 17 C.F.R. § 240.19b-2 (1974).

The course of events leading to the adoption of Rule 19b-2 makes the political explanation of the congressional response particularly persuasive. Even though Rule 19b-2 was adopted four months *after* the House Securities Industry Study was published, it is plain from the SEC report accompanying the issuance of Rule 19b-2 that conflicts-of-interest had little to do with the adoption of the Rule. Almost the entire substantive justification for the Rule derives from a perceived need to retain the "public" character of the markets and to save the market from institutional domination. See SEC Securities Exchange Act Release No. 9950, at 10-36, 45-53, 90-129, 130-134 reprinted in summary form in [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,178, at 82583 (Jan. 16, 1973). Yet Rule 19b-2 does nothing to diminish institutional domination of member firms. On the contrary, Rule 19b-2 was designed to permit a member to manage nothing but institutional business so long as the firm was not in a control relationship with the institutions it was managing. Furthermore, control is defined rather liberally. Control is presumed if one person has a right to participate to the extent of more than twenty-five percent in the profits of the other person or owns more than twenty-five percent of the outstanding voting securities of the other person. See 17 C.F.R. § 240.19b-2 (1974). As further proof that competitive advantage rather than conflict-of-interest lies at the heart of the brokerage and money management issue, not all stock exchanges were ecstatic about Rule 19b-2. Several exchanges had expanded their membership by making their facilities available to institutional advisers as a means of recapturing excess commissions. See, e.g., Welles, *The War Between the Big Board and The Regionals: What it Means to the Business, Institutional Investor*, Dec. 1970, at 21. The PBW Exchange was so upset by Rule 19b-2 that it filed suit against the Commission to prevent enforcement of the rule, though it met with no success. *PBW Stock Exch., Inc. v. SEC*, 485 F.2d 718 (3d Cir. 1973).

The irony is that, although separation of brokerage from management is all but settled for institutional accounts,¹⁴⁵ broker-dealers are to be permitted to continue executing for managed individual accounts. If there were any group of investors seriously threatened by the conflicts-of-interest listed above, it would be that of the individual investor. Arguably, individual investors lack the sophistication necessary to understand when they are being victimized by over-trading, inferior executions, or dumping. Perhaps because non-broker-dealer investment advisers managing individual accounts lacked the lobby of the institutions, or because such advisers are dependent on the good graces of broker-dealers in obtaining referrals, individual investors have not been deemed in need of the protection being afforded the institutions.

The exclusion of individual accounts from the proposed prohibition on brokerage for managed accounts, however, does not mean that the regulatory climate for broker-dealers managing accounts for individuals will remain unchanged. For one thing, the separation of brokerage and management for institutional accounts permits federal and state authorities to concentrate more regulatory and enforcement effort on broker-dealers executing for their managed accounts. But a far more important phenomenon affecting the arrangements between broker-dealers and their managed accounts is the introduction of negotiated commission rates. For it will soon be possible, by the simple device of applying all commission income against the advisory fee, to eliminate many of conflicts-of-interest arising out of a broker-dealer manager's dual status.

Temptations to churn in order to promote the broker-dealer manager's own commission income, as the Senate Securities Industry Study notes, can be eliminated by crediting profits received from in-house executions against the advisory fee.¹⁴⁶ Similarly,

¹⁴⁵ At one time, the House Subcommittee responsible for H.R. 5050 approved an amendment that would permit broker-dealers to execute for unaffiliated managed accounts. See Wall Street Letter, Aug. 12, 1974, at 3, col. 1. But opposition to modification of the absolute prohibition of the original bill was immediate and firm. Indeed, the source and intensity of the opposition gives added weight to the view that the presence of conflicts-of-interest does not explain the separation of brokerage and management. Broker-dealers were afraid banks and insurance companies would enter into competition with their brokerage business. And banks and insurance companies were afraid broker-dealers would gain an advantage in competing for institutional accounts. See Securities Week, Aug. 26, 1974, at 4. Eventually, H.R. 5050 was marked up and reported out of committee prohibiting combined brokerage and management, but permitting the SEC to exempt managers providing only advisory services to managed accounts. See *id.*, Oct. 14, 1974, at 2. The purpose of the exemption is to enhance the competitive position of broker-dealers but it apparently faces a doubtful future. See Securities Week, Nov. 11, 1974, at 2; Wall Street Letter, Nov. 11, 1974, at 1; *Id.*, Oct. 14, 1974 at 6, col. 2.

¹⁴⁶ Senate Study, *supra* note 4, at 75. After reciprocal brokerage practices fell into regulatory disfavor, a number of institutions began joining various securities exchanges, either directly or through affiliates, in order to reduce commission expense and to recapture commis-

temptations toward deliberate sacrifice of best execution by a broker-dealer manager for his own pecuniary benefit, through choice of an inferior market, can be handled in the same way as churning. By crediting all profits from commissions against advisory fees, incentives to sacrifice best execution disappear. Even where the conflict-of-interest pressuring best execution is more subtle than choice of market, the problem is more apparent than real. For example, good faith notwithstanding, it may look improper to have a broker-dealer negotiate a "fair" commission with a discretionary account. But if commission profits are credited against advisory fees and best execution is equated with best price for house-managed accounts,¹⁴⁷ the only risk to the client is that his broker-dealer manager will be mistaken about the place for best execution, not that the manager's judgment will be colored by an opportunity for personal gain.

There is ample reason to believe that arrangements which credit commission income against advisory fees would evolve without regulation after negotiated commissions become law. Even in the fixed-commission era, many broker-dealers were offering reduced advisory fees in anticipation of commission income.¹⁴⁸ But it is entirely possible that existing principles of fiduciary responsibility will oblige broker-dealer managers to forego profits on trades executed for managed accounts. The present barrier to such arrangements is the stock exchange anti-rebate rules which are soon to fall victim to negotiated rates. Once managers obtain the authority to return profits from commissions to clients, fiduciary law may prevent them from choosing their own houses for executions if they will receive profits from the commissions beyond those available from the advisory fee.¹⁴⁹

In addition to conflicts-of-interest involving the frequency and quality of executions, the Senate and House studies of the securities industry also mention other conflicts-of-interest said to be associated with the combination of brokerage and management. Analysis shows that two of the suggested conflicts-of-interest, however much of a problem they may be, have little to do with a broker-dealer manager's dual status. One is preferential treatment for managed

sions. See *id.* at 64-74. Even before reciprocity fell into official disapproval, a number of broker-dealer managers were setting lower advisory fees for their clients in anticipation of the commission income. See, e.g., *Wall Street Journal*, Nov. 29, 1972, at 18, col. 2 (describing a small NYSE member firm which managed its own mutual fund). The advisory contract provided that one-third of the brokerage fees received from the fund were to offset the management company's fees.

¹⁴⁷ Fiduciary principles will not permit a broker-dealer manager to execute in-house at greater than best price. See text at notes 112-15 *supra*.

¹⁴⁸ See *Institutional Investor Study*, *supra* note 1, at 213. See note 146 *supra*.

¹⁴⁹ See 17 C.J.S. Contracts § 184, 974 (1963).

accounts. Certainly, preference given such accounts is no cause for concern for those clients. It is the firm's other customers who suffer the injury, if any.¹⁵⁰ But unless those other customers are being led to believe they are receiving the same services at the same time as the managed accounts, the issue seems to be more one of public policy (*i.e.*, whether such preferences should be permitted) than conflict-of-interest. In any event, it is difficult to understand how preferential treatment will be affected by separating brokerage and management. Research will still go first to the more valued customers, meaning, apparently, the managed accounts. Furthermore, executions also will go first to the managed accounts in the firms which give them preferential treatment. Insofar as institutional investors are concerned, the only difference resulting from the pending House and Senate bills would be that the trades will be executed by other houses. Then there is the question of scalping, the other conflict-of-interest having little to do with combined brokerage and management. Apparently the House subcommittee believes there will be less scalping if brokerage is separated from management.¹⁵¹ But all scalping requires is that the scalper trade for his own account¹⁵² or for his favored accounts¹⁵³ in advance of making purchases or sales for his managed accounts. No scalper needs to employ his own brokerage facilities to engage in such a perversion of his fiduciary duty.

Dumping is the one conflict-of-interest identified by the House and Senate securities-industry studies which is associated with brokerage for managed accounts and which cannot be eliminated by negotiated commission rates. Broker-dealers may take over-valued stock from inventory or from favored accounts and place it into less-favored accounts. If the problem is serious, temptations to dump can be eliminated by prohibiting the broker-dealer manager from dealing with the client as principal or as agent for another. However, no such prohibition is necessary so long as the broker-dealer makes full disclosure to his client and receives advance writ-

¹⁵⁰ Absolute fairness in the sense of equal treatment for all accounts may be impossible to achieve in any event. As the Institutional Investor Study noted, "delaying executions for discretionary accounts while awaiting the decisions of the other advisory clients might be considered a breach of the adviser's duty to the discretionary account." Institutional Investor Study, *supra* note 1, at 349 n.171.

¹⁵¹ House Study, *supra* note 4, at 148-49.

¹⁵² Scalping for one's own account is a statutory, if not common-law, fraud. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 201 (1963).

¹⁵³ It is difficult to determine the basis on which an adviser would prefer one set of discretionary accounts above another set of discretionary accounts, but apparently some firms may favor institutional clients over public clients and some do precisely the opposite. See Folk, *Restructuring the Securities Markets—The Martin Report: A Critique*, 57 Va. L. Rev. 1315, 1363-64 (1971).

ten approval from his client to consummate the transaction—along the lines now required by section 206(3) of the Advisers Act.¹⁵⁴ Moreover, an absolute law of this type can be harmful to clients. For example, both pending bills, recognizing that block positioners often act to their client's benefit in trading as principal,¹⁵⁵ exempt such transactions from the proposed statutory prohibition against combined brokerage and management.¹⁵⁶

III. CONCLUSION

In light of the current state of the federal securities laws, broker-dealers offering discretionary management services face an unhappy future. Unless the *Continental Commodities*¹⁵⁷ construction of investment contract is undercut,¹⁵⁸ discretionary accounts will have to be registered as securities. Unless the SEC's position in the *First National City Bank*¹⁵⁹ case is modified, the discretionary accounts, taken collectively,¹⁶⁰ of an individual broker-dealer will have to be registered as an investment company. Unless section

¹⁵⁴ 15 U.S.C. § 80b-6 (1970), which states:

It shall be unlawful for any investment advisory by the use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction

¹⁵⁵ Block positioners prefer not to tie up their own capital when they handle orders for their customers. A price must be provided, however, within a reasonable period of time, which usually precludes the collection of sufficient commitments on the other side of the order to match the initial customer's desires. The result is that a block positioner may have to inventory part of the position himself. Given the capital it requires, the number of block positioners is small. To prohibit such houses from executing block transactions for their advisory clients would effectively cut their clients out from a significant portion of the market, and would thus disadvantage block positioning houses in the provision of management services. For a discussion of the mechanics of block trading, see Institutional Investor Study, *supra* note 1, pt. 4, at 1584-1720.

¹⁵⁶ S. 470 § 2, amendment to § 11 of the Securities Exchange Act, 15 U.S.C. § 78k (1970), § 11(f)(2)(C); H.R. 5050 § 205, amendment to the Securities Exchange Act, § 11(a)(2)(C).

¹⁵⁷ 497 F.2d 516 (5th Cir. 1974).

¹⁵⁸ See notes 44-46 *supra*.

¹⁵⁹ See text at note 60 *supra*.

¹⁶⁰ The SEC takes the position that common management can create a statutory investment company even when the accounts of investors are being handled by an exempt institution. It regards the group of accounts together as the investment company, whatever the character of the institution providing management services. This theory of the creation of a statutory investment company is called the "ectoplasmic theory" and was successfully litigated to a conclusion in *Prudential Ins. Co. of America v. SEC*, 326 F.2d 383 (D.C. Cir. 1964), cert. denied, 377 U.S. 953 (1964), in which it was applied against the separate account underlying a variable annuity program.

202(a)(11)¹⁶¹ is interpreted generously, broker-dealer discretionary managers will have to be registered as Advisers Act investment advisers.¹⁶² And unless there is a change in political attitudes, broker-dealers will be restricted from trading for managed institutional accounts and restrained in trading for managed individual accounts.¹⁶³

These developments also present serious problems for broker-dealers making referrals to others offering discretionary management services. Once it is established that discretionary accounts are statutory securities, such broker-dealers would be Securities Act statutory underwriters,¹⁶⁴ Investment Company Act principal underwriters if they shared fees for the referrals,¹⁶⁵ and Investment Company Act statutory underwriters otherwise.¹⁶⁶ They also would probably have to be registered as Advisers Act investment advisers.¹⁶⁷ And finally, depending on the final construction of the legislation prohibiting combined brokerage and management, they may well have to give up trading on an exchange for accounts they have referred.¹⁶⁸

If the securities laws and regulations had been purposely designed to create uncertainty and discourage broker-dealer entry into the discretionary advisory business without expressly prohibiting broker-dealers from offering such services, it is hard to imagine how this could have been better accomplished. To be sure, much of what the broker-dealers face is also faced by other, more traditional, investment advisers. If a discretionary account is a security for a broker-dealer, it is similarly classified for every other type of man-

¹⁶¹ 15 U.S.C. § 80b-2(a)(11)(C) (1970).

¹⁶² See text at notes 103-15 *supra*.

¹⁶³ See text at notes 131-36 *supra*.

¹⁶⁴ See note 32 *supra*.

¹⁶⁵ The definition of "principal underwriter" in § 2(a)(29) of the Investment Company Act includes "any underwriter . . . who as agent . . . sells any . . . security [in an investment company] . . . to the public . . ." 15 U.S.C. § 80a-2(a)(29) (1970). For a definition of underwriter, see note 166 *infra*.

¹⁶⁶ The definition of "underwriter" in § 2(a)(40) of the Investment Company Act includes "any person who . . . sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking . . ." 15 U.S.C. § 80a-2(a)(40) (1970).

¹⁶⁷ See text at notes 127-30 *supra*.

¹⁶⁸ The construction of § 205 of H.R. 5050, 93d Cong., 1st Sess. (1973), (reintroduced as H.R. 10, 94th Cong., 1st Sess. 1975) is to prohibit exchange transactions between the broker-dealer manager and any affiliated person. Affiliate is defined to include any member "empowered to determine what securities or other property shall be purchased or sold or is otherwise authorized to select the securities bought or sold." *Id.* This language could well be interpreted to apply to broker-dealers who act as custodians and brokers for accounts referred to other investment advisers because of their duties as custodians and brokers and because of the continuing obligation of such broker-dealers to evaluate and monitor the management of these accounts. See text at notes 127-30 *supra*.

ager. If a set of discretionary accounts is an investment company, it is so whatever type of manager acts as adviser. As a tactical matter, however, the SEC is not going to establish a new regulatory regime by attacking its strongest adversaries. Banks, investment counselors and insurance companies have been offering discretionary management services for years without any suggestion from the Commission that solely because of their discretionary management activities, they have been issuing registered securities or managing unregistered investment companies.¹⁶⁹ Moreover, the clientele of these advisers is typically made up of institutions and wealthy individuals. Measured by need for federal securities law protection, such an environment would severely test the statutory security and investment company analogies.

But the broker-dealer community presents a different kind of target. Measured by its impact, it is a relatively new entrant into the discretionary management business. Also, although the situation has its ironies, broker-dealers offering discretionary management services present an inferior regulatory posture to that of other investment managers. Broker-dealers, with a long history of tight regulation for all their traditional activities, give the impression of requiring comparable regulation for their discretionary management activities; yet their discretionary management activities are currently the least regulated of those of all investment managers. Finally, and perhaps most important of all, a far greater proportion of the discretionary management business of broker-dealers is directed at individual investors of modest means. As *Continental Commodities*, the pyramid and condominium cases under the Securities Act,¹⁷⁰ and *First National City Bank* under the Investment Company Act,¹⁷¹ demonstrate, the SEC is especially vigorous about extending its jurisdiction to cover previously unregulated securities matters

¹⁶⁹ It is not entirely accurate to say the Commission has given no indication that discretionary management by investment advisers of a more traditional type may require registration under and compliance with various federal securities laws. In the spring of 1974, the Commission requested comment on its role in dealing with bank-sponsored investment services. See SEC Securities Act Release No. 5491, reprinted in [1973-74 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,767, at 84070 (Apr. 30, 1974). See note 65 supra.

¹⁷⁰ A discussion of the factors that would cause the SEC to find that a condominium offering is an offer for sale of a security is found in SEC Securities Act Release No. 5347, reprinted in [1972-73 Transfer Binder] CCH Fed. Sec. Rep. ¶ 79,163, at 82535 (Jan. 4, 1973). Several commentators have addressed the matter of condominiums as securities. E.g., Clurman, *Condominiums as Securities: A Current Look*, 19 N.Y.L. Forum 457 (1974); Dickey & Thorpe, *Federal Security Regulation of Condominium Offerings*, 19 N.Y.L. Forum 473 (1974); Rosenbaum, *The Resort Condominiums and the Federal Securities Laws—A Case Study in Governmental Inflexibility*, 60 Va. L. Rev. 785 (1974). The principal pyramid cases are SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir. 1973), cert. denied, 414 U.S. 821 (1973).

¹⁷¹ See text at notes 61-70 supra.

having dangerous potential for unsophisticated individual investors.¹⁷²

It may be, of course, that broker-dealer expansion into money management is contrary to the public interest. Perhaps, because of the ease of entry into the brokerage industry, there is too great a possibility that investors will entrust their assets to unscrupulous or incompetent persons.¹⁷³ Or perhaps, the proper functioning of the securities markets requires broker-dealers to concentrate on trading and distributing securities to the exclusion of other activities. Neither Congress nor the SEC has publicly taken such a position. On the contrary, public statements have been to the effect that unfair restrictions on broker-dealer competition for advisory business are not desirable policy.¹⁷⁴ Presumably, then, regulatory developments should not be accomplishing indirectly what is disavowed officially.

There is another explanation for the unsettled state of affairs respecting the provision of discretionary management services by broker-dealers. The federal regulation of investment management has become so balkanized that current events can be explained as a movement toward consolidation. For many years, underwriters, broker-dealers, insurance companies, investment counselors, and banks, the principals in the securities business, have been regulated by separate administrative authorities. Even where regulated by one authority, their activities fall under the jurisdiction of separate organic statutes. At some point, compartmentalized regulation of comparable activities creates discontinuities that generate

¹⁷² The Ninth Circuit in *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476 (9th Cir. 1973), after graphically describing the operations of the "Dare To Be Great" pyramid scheme, was quite open in characterizing the definition of securities as functional rather than technical:

[T]he definition of securities should be a flexible one, [and] the word "solely" [in *Howey*] should not be read as a strict or literal limitation on the definition of an investment contract Rather we adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.

Id. at 482.

For a recent example of the willingness of the federal courts on their own initiative to extend the definition of security on the basis of commonality of services rather than commonality of investment decisions, see *Safeway Portland Employees Fed. Credit Union v. C.H. Wagner & Co.*, 501 F.2d 1120 (9th Cir. 1974) (brokered loan transactions as investment contracts).

¹⁷³ It is worth pointing out, however, that as easy as it may be to enter into the brokerage industry, it is far easier to become a registered investment adviser. Moreover, given the current state of the law, the costs of being a law-abiding broker-dealer are much greater than the costs of being a law-abiding investment adviser, for regulation of broker-dealers under the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78hh-1 (1970), is far more onerous than regulation of investment advisers under the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1970).

¹⁷⁴ See House Study, *supra* note 4, at 149-50; Senate Study, *supra* note 4, at 86-87. Cf. Special Study, *supra* note 20, at 190.

unreasonable strain. The natural response is to find a common basis for regulating the activities of all of these entities as nearly alike as possible. This is the case with discretionary management.

But the problem is that the SEC lacks the tools to consolidate properly. A discretionary account, if a security, is not only a security for every type of manager, but also for every type of discretionary account. The Securities Act offers no basis for distinguishing the largest pension fund from the smallest discretionary investment plan. The Investment Company Act offers no basis for distinguishing a group of discretionary accounts managed alike by an insubstantial broker-dealer from a group of institutional accounts managed by an institutional adviser. The consequence of using statutory authority of questionable relevance to regulate activities that require agency protection, as appears to be the case now with discretionary management, is the imposition of costly regulatory burdens on many other entirely satisfactory arrangements. It may well be that discretionary management at all levels, and of all types, is in need of investigation in order to arrive at an appropriate regulatory posture. But the existing federal securities laws are inadequate to the task. However much the Commission believes that the advisory activities of banks, for example, should be brought under its jurisdiction for certain purposes, the Securities Act is hardly the regulatory tool for doing so.¹⁷⁵ Similarly, however much the SEC believes that small investors holding securities in discretionary accounts require protections comparable to those available to shareholders of investment companies, the Investment Company Act is hardly the proper means to provide such protections.¹⁷⁶

The regulation of investment advisory activities under the Securities Act and the Investment Company Act can be criticized on practical grounds also. Presumably, it is the practices of investment advisers which require regulation, not their discretionary authority. Yet, a good many advisers will not accept discretionary authority

¹⁷⁵ See note 64 *supra*. The SEC's extension of its jurisdiction to condominium offerings is another excellent example of the use of the Securities Act to control questionable practices in circumstances where the fit between the regulated vehicle and the statute is poor. See Rosenbaum, *The Resort Condominium and the Federal Securities Laws—A Case Study in Governmental Inflexibility*, 60 Va. L. Rev. 785 (1974). Accord, *Loehwing, Condominiums to Oysters*, *Barron's*, Jan. 7, 1974, at 5, col. 1.

¹⁷⁶ Should the Investment Company Act be held applicable to management of discretionary accounts, the SEC would have to choose between prohibiting discretionary management services or creating great numbers of exemptions from the provisions of the Investment Company Act for discretionary account managers. One advantage that might flow from holding the Investment Company Act applicable to discretionary management services would be the opportunity for creative use of the exemptive power of the SEC under § 6(c) of the Investment Company Act, 15 U.S.C. § 80a-b(c) (1970), to require those providing discretionary management services to meet certain minimum regulatory standards in order to qualify for exemptions. See text at notes 184-86 *infra*.

over the accounts they manage even though they are responsible for selecting investments and timing market moves. To some extent the refusal to accept discretionary authority may be a reflection of the expanding scope of the Securities Act and Investment Company Act. But in many cases, clients themselves either will not or cannot extend discretionary authority to advisers.¹⁷⁷ In any event, the relevant distinction in the industry is between managed and unmanaged accounts rather than between discretionary and non-discretionary accounts. Indeed both S. 470 and H.R. 5050 took precisely that line in determining where to limit trading for advisory accounts.¹⁷⁸

Of course, if the theory takes hold that an investment contract results from any arrangement in which assets at risk do not belong to the party responsible for producing the return,¹⁷⁹ the Securities Act and Investment Company Act could apply with equal logic to all managed accounts, whether discretionary or non-discretionary. A better answer would be new legislation. Reports from Washington indicate that Congress is soon to examine the need for expanding the coverage of the Advisers Act.¹⁸⁰ That would certainly be a good opportunity for rationalizing the existing disparities. My recommendation, should modification of the Advisers Act be seriously considered, would be to make the subject of the legislative inquiry far broader than that single statute. The federal securities laws have outlived their entity orientation. Investment bankers, broker-dealers, banks, insurance companies, investment company advisers and investment counselors are no longer the distinctive organizations they once were. Everyone, it seems, is getting into everyone else's business.¹⁸¹ With classifications becoming so blurred, it makes

¹⁷⁷ There is some question, for example, whether trustees of an educational or charitable endowment can give discretionary authority to outside investment managers. See, e.g., Cary & Bright, *The Delegation of Investment Responsibility for Endowment Funds*, 74 *Colum. L. Rev.* 207 (1974).

¹⁷⁸ See, e.g., S. 470, 93d Cong., 1st Sess. (1973), which defines a managed institutional account:

[A]n account of a bank, insurance company, trust company, investment company, separate account, pension-benefit or profit-sharing trust or plan, foundation or charitable endowment fund, or other similar type of institutional account for which such member or any affiliated person thereof (A) is empowered to determine what securities shall be purchased or sold, or (B) makes day-to-day decisions as to the purchase or sale of securities even though some other person may have ultimate responsibility for the investment decisions for such account.

¹⁷⁹ See text at note 45 *supra*.

¹⁸⁰ See Wall Street Letter, Sept. 16, 1974 at 7, col. 1.

¹⁸¹ Banks, for example, are now finding it worthwhile to take on certain brokerage functions. See Cole, *Should Banks Be Allowed a Stockbroker Role?*, *N.Y. Times*, Oct. 28, 1974, at 49, col. 1. Much of the movement into new investment-related services can be explained as a response to the growing complexity involved in providing financial assistance to investors of all types, whether individuals, business organizations or institutions. The

much more sense now to regulate operations based on what they do rather than what they call themselves.¹⁸² Such an approach would mean that all investment managers handling discretionary accounts would be able to look to a common source of regulation, and that if distinctions were to be carved out, such distinctions would be based on express policy rather than accidents of fate.

Until that time, however, little encouragement can be offered to broker-dealers involved, or planning to become involved, in providing investors with discretionary management services. Their exposure under existing law is already great, and with the current market situation, the number of dissatisfied clients apt to complain to the SEC or seek civil remedies is surely large and continuing to grow. As a first step toward rationalizing the existing situation and protecting broker-dealers from the open-ended liabilities they now face, the SEC should seriously consider using its rule-making power to force regulation of discretionary management under the Investment Advisers Act. It could, through a safe-harbor approach,¹⁸³ define "investment contract" under the Securities Act so as to exclude discretionary accounts managed by registered investment advisers in compliance with regulatory requirements pertaining to discretionary management imposed under the Advisers Act.¹⁸⁴ In like fashion, the Commission could condition exemption from the Investment Company Act on registration under the Advisers Act

adviser able to offer a full range of financial services of high quality including capital preservation, capital acquisitions, insurance, trading capabilities, custodianship, and so forth, has a distinct competitive advantage over the adviser whose specialization makes his perspective more limited. See Welles, *Where Will Wall Street Profits Come From?*, *Institutional Investor*, Sept. 1972, at 33.

¹⁸² This seems to be the approach now being taken by the American Law Institute in its current engagement to produce a model federal securities code. As Professor Loss, the reporter for the code, pointed out when the project was first undertaken, the federal securities laws now contain a great number of conflicting demands arising out of the application of different statutes to a single transaction or a single activity. He views one of the major contributions of his efforts for the ALI to be a sharp reduction in these kinds of conflicting jurisdictional demands. See L. Loss, *Federal Securities Code*, Reporter's Introductory Memorandum xiii-xli (Tent. Draft No. 1, 1972).

¹⁸³ See L. Loss, *Securities Regulation*, ch. 12E, at 1942-43 (1961).

¹⁸⁴ Section 19 of the Securities Act provides: "(a) the Commission shall have authority from time to time to make . . . such rules and regulations as may be necessary for carrying out the provisions of this title including rules and regulations . . . defining accounting, technical, and trade terms used in this title." 15 U.S.C. § 77s (1970). By defining investment contract to insulate complying discretionary management services from application of the Securities Act, the Commission would protect account managers from civil liability under the Act. Section 19(a) further provides:

No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any purpose.

Id.

and compliance with appropriate regulations.¹⁸⁵ Such a procedure would not only aid broker-dealers involved in the provision of discretionary management services, it would also enable the Commission to regulate many practices of which it apparently disapproves but against which it has taken no action.¹⁸⁶ At the very least, rule-making proceedings would provide a focus for ventilating different points of view about the proper regulatory goals for dealing with the provision of discretionary management services by investment advisers of all kinds.

¹⁸⁵ Section 6 of the Investment Company Act provides: "(c) The Commission, by rules and regulations upon its own motion . . . may conditionally . . . exempt any person, security or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter . . ." 15 U.S.C. § 80a-6 (1970). An example of broad and creative use of this exemptive power is its use to promote investor protection in the offering of variable life insurance by conditioning exemption on adequate supervision by state insurance commissioners. See note 72 *supra*.

¹⁸⁶ The individualization guidelines suggested for small investors have existed for two years without any affirmative steps to implement the Committee's recommendations having been taken. See, e.g., Advisory Comm. Report, *supra* note 2, at 27-32.