

# PUBLIC

SEP 5 1995

**RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT**

Our Ref. No. 95-176-CC  
SMC Capital, Inc.  
File No. 132-3

By letter dated July 11, 1995, you request our assurance that we would not recommend enforcement action to the Commission under section 17(d) of the Investment Company Act of 1940 ("Investment Company Act") or rule 17d-1 thereunder, or section 206 of the Investment Advisers Act of 1940 ("Advisers Act"), if SMC Capital, Inc. ("SMC"), a registered investment adviser, aggregates orders for the purchase or sale of securities on behalf of its clients, as more fully described in your letter.

You state that SMC provides investment advice to a number of different types of clients, including individuals, employee benefit plans, registered investment companies, private investment limited partnerships excepted from the definition of "investment company" under section 3(c)(1) of the Investment Company Act, and insurance company investment accounts. Employees and principals of SMC invest in certain collective investment vehicles advised by SMC.

You state that larger orders for the purchase or sale of securities generally may be executed at lower commission costs on a per-share and per-dollar basis than smaller orders. SMC believes it is obligated to seek the best possible execution of all trades for all its clients, including those clients in which persons associated with SMC 1/ are among the investors, by engaging in the aggregation of orders. 2/ You also state that, if orders are aggregated in accordance with the standards outlined in your letter, the risk that any particular client would be or could be systematically advantaged or disadvantaged would be minimized.

**Proposed Aggregation of Orders**

Specifically, SMC proposes to aggregate client orders as follows:

1. Policies for the aggregation of transactions will be fully disclosed in SMC's Form ADV and separately to SMC's existing clients and the broker-dealers through which such orders are placed 3/;
2. SMC will not aggregate transactions unless it believes that aggregation is consistent with its duty to seek best execution (which includes the duty to seek

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1/ A "person associated with an investment adviser," as defined in section 202(a)(17) of the Advisers Act, includes any partner, officer, or director of the investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by the investment adviser, including any employee of the investment adviser (other than employees whose functions are clerical or ministerial).

2/ We note that an adviser would not violate its duty to seek best execution merely by failing to aggregate orders for client accounts. The adviser should, however, disclose to its clients that it will not aggregate and the potential consequences of the failure to aggregate. See In re Mark Bailey, Investment Advisers Act Release No. 1105, 40 SEC Docket 432 (Feb. 24, 1988).

3/ Your letter states that the policies for the aggregation of transactions will be submitted to and approved by the board of directors of any registered investment company for which transactions will be aggregated.

best price) for its clients and is consistent with the terms of SMC's investment advisory agreement with each client for which trades are being aggregated;

3. No advisory client will be favored over any other client; each client that participates in an aggregated order will participate at the average share price for all SMC's transactions in that security on a given business day, with transaction costs shared *pro rata* based on each client's participation in the transaction;
4. SMC will prepare, before entering an aggregated order, a written statement (the "Allocation Statement") specifying the participating client accounts and how it intends to allocate the order among those clients; 4/
5. If the aggregated order is filled in its entirety, it will be allocated among clients in accordance with the Allocation Statement; if the order is partially filled, it will be allocated *pro rata* based on the Allocation Statement;
6. Notwithstanding the foregoing, the order may be allocated on a basis different from that specified in the Allocation Statement if all client accounts receive fair and equitable treatment and the reason for the different allocation is explained in writing and is approved in writing by SMC's compliance officer no later than one hour after the opening of the markets on the trading day following the day the order was executed; 5/
7. SMC's books and records will separately reflect, for each client account the orders of which are aggregated, the securities held by, and bought and sold for, that account;
8. Funds and securities of clients whose orders are aggregated will be deposited with one or more banks or broker-dealers, and neither the clients' cash nor their securities will be held collectively any longer than is necessary to settle the purchase or sale in question on a delivery versus payment basis; cash or

4/ In a telephone conversation on August 29, 1995, Mercer E. Bullard of Wilmer, Cutler & Pickering represented that Allocation Statements, and written statements explaining any deviations therefrom, will be maintained as records of SMC in an easily accessible place for a period of not less than five years, the first two years in an appropriate office of SMC.

5/ For example, it may be appropriate to deviate from the Allocation Statement when, subsequent to entering the trade but before the final allocation, SMC determines that the security in question would be unsuitable for one of the clients designated in the Allocation Statement.

You also represent that if an aggregated purchase or sale order is partially executed and allocated on a basis different from that specified in the Allocation Statement, no client that is benefitted by the different allocation may effect any purchase or sale, for a reasonable period following the execution of the aggregated order, that would result in its receiving or selling more shares than the number of shares it would have received or sold had the aggregated order been fully executed.

- securities held collectively for clients will be delivered out to the custodian bank or broker-dealer as soon as practicable following the settlement;
9. SMC will receive no additional compensation or remuneration of any kind as a result of the proposed aggregation; and
  10. Individual investment advice and treatment will be accorded to each advisory client.

You state that SMC has procedures and mechanisms in place that are reasonably designed to implement its aggregation policies. 6/

#### Analysis

Section 17(d) of the Investment Company Act provides that the Commission may adopt rules restricting participation by registered investment companies in joint transactions with affiliated persons for the purpose of preventing or limiting participation by such a company on a basis different from or less advantageous than that of any other participant. Rule 17d-1, in relevant part, provides that no affiliated person of a registered investment company, and no affiliated person of an affiliated person, may participate in any joint enterprise, arrangement, or profit-sharing plan, as defined in the rule, without first obtaining an exemptive order from the Commission. Your letter raises issues under section 17(d) because SMC proposes to aggregate orders on behalf of registered investment company clients and other advisory clients in which persons associated with SMC have invested, or other clients that may be affiliated persons of the registered investment company, or affiliated persons of such persons. 7/

Some element of combination or profit motive must generally be present for section 17(d) and rule 17d-1 to apply. 8/ You maintain that the aggregation of orders alone does

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- 6/ Telephone conversation with Mercer E. Bullard on August 29, 1995. Additionally, Mr. Bullard represented that SMC will annually review its aggregation procedures to ensure that they are adequate to prevent any account from being systematically disadvantaged as a result of the aggregation of orders. If SMC discovers that its aggregation policies are not being adhered to, SMC will take whatever corrective measures are necessary, including revising its procedures.
- 7/ Section 2(a)(3) of the Investment Company Act defines an affiliated person of another person to include, among other things, any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the other person, any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the other person, or any investment adviser of an investment company.
- 8/ In re Steadman Security Corp., 1974-75 Fed. Sec. L. Rep. (CCH) ¶ 80,038 at 84,848 (Dec. 20, 1974) (rule 17d-1 "is concerned with joint enterprises or joint arrangements that are in the nature of a joint venture, *i.e.*, that involve the element of seeking to realize a profit or gain through the investment of funds."); SEC v. Talley Indust., Inc., 399 F.2d 396, 403 (2d Cir. 1968), cert. denied, 393 U.S. 1015 (continued...)

not constitute a combination or enterprise conducted for the purpose of making a profit. A pattern of aggregating trades on behalf of certain clients, you contend, results only from a commonality of investment objectives, not from any motive or purpose related to the execution of the orders. In the alternative, you state that because all of SMC's clients will participate on equal terms, the proposed aggregation of trades need not be prohibited in order to effectuate the policies underlying section 17(d).

We agree that the mere aggregation of orders for advisory clients 9/, including a registered investment company, would not violate section 17(d), provided that the investment company participates on terms no less advantageous than those of any other participant. If a portfolio manager allocates trades in such a way as to disadvantage a registered investment company, however, a joint enterprise or arrangement raising the concerns section 17(d) was designed to address may result. 10/

We would not recommend enforcement action to the Commission under section 17(d) or rule 17d-1 thereunder if SMC engages in the practice of aggregating orders for the purchase or sale of securities on behalf of investment companies and other clients (including clients in which SMC or persons associated with SMC may have an interest), subject to the representations made in your letter and the telephone conversations. 11/ Nor would we recommend enforcement action to the Commission under section 206 of the Advisers Act if SMC engages in the proposed aggregation of orders in a manner consistent with seeking best execution, subject to the representations made in your letter and the telephone conversations. 12/ Section 206 imposes a fiduciary duty on an investment adviser to act in

8/(...continued)

(1969) (while section 17(d) is not limited to the typical joint venture, "some element of 'combination' is required").

9/ Advisory clients include collective investment vehicles in which the adviser, its principals or employees have an interest.

10/ In re Kemper Financial Services, Inc., Investment Advisers Act Release No. 1387, Fed. Sec. L. Rep. (CCH) ¶ 85,237 (Oct. 20, 1993). The anti-fraud provisions of the federal securities laws also would apply to transactions that were allocated in order to benefit certain clients over others. In particular, section 17(j) of the Investment Company Act and rule 17j-1(a) thereunder, in relevant part, generally prohibit any affiliated person of a registered investment company, in connection with the purchase or sale by such person of a security held or to be acquired by such registered investment company, from defrauding such registered investment company. Therefore, these provisions prohibit fraudulent practices in connection with aggregated trades in which an investment company and affiliated persons of the investment company participate. *See also* section 206 of the Advisers Act.

11/ SMC states that it will allocate trades at an average price and, if not completely filled, on a *pro rata* basis. Although you have not asked us to express an opinion on any other allocation method, we note that there may be other allocation methods that advisers can use without violating section 17(d) or section 206.

12/ The fact that an aggregated order results in best execution, however, does not necessarily remove the transaction from section 206 or section 17(d), if the adviser  
(continued...)

the utmost good faith with respect to its clients, and to provide full and fair disclosure of all material facts. 13/ Consistent with its fiduciary duties, SMC will allocate trades on an equitable basis with respect to both its investment company and non-investment company clients. Our position with respect to section 206 is based particularly on the following representations: (1) the practice of aggregating orders will be fully disclosed in SMC's Form ADV and separately to SMC's existing clients, and (2) no advisory client, including those clients in which SMC or persons associated with SMC have a direct or indirect beneficial interest, will be favored by SMC over any other client and each client who participates in an aggregated order will participate at the average share price with all transaction costs shared on a *pro rata* basis. 14/

Because this position is based on the facts and representations made in your letter and the telephone conversations noted above, you should note that any different facts or circumstances might require a different conclusion. 15/

Karrie McMillan  
Senior Counsel

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12/(...continued)

derives a personal gain from the transaction or favors certain clients over others. See SEC v. Talton R. Embry and Magten Asset Management, Litigation Release No. 13777 (Sept. 9, 1993). In Embry, the Commission alleged that the principal of the adviser aggregated his own purchases with those of his clients, including some registered investment companies, and then immediately sold the securities he had purchased for himself at a higher price in pre-arranged sales. Although the principal may have obtained best execution for his clients, he was enjoined from violating section 206 and section 17(d) because he aggregated the trades to make a profit for himself.

- 13/ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 184 (1963).
- 14/ This letter does not address any issues regarding the aggregation of orders that may arise under the Employee Retirement Income Security Act of 1974 ("ERISA"), such as whether aggregating trades for proprietary accounts with trades for ERISA accounts violates the exclusive benefit rule of section 404(a) of ERISA, or constitutes a prohibited transaction under section 406 of that Act.
- 15/ Your letter does not request relief with respect to the aggregation of orders involving privately placed securities, and therefore we express no opinion with respect to the aggregation of such securities.

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\*NOT ADMITTED IN D. C.

## Investment Company Act 17(d)/Rule 17d-1

July 11, 1995

Jack W. Murphy  
 Chief Counsel  
 Division of Investment Management  
 Securities and Exchange Commission  
 Mail Stop 10-6  
 450 Fifth Street, N.W.  
 Washington, D.C. 20549

Dear Mr. Murphy:

We are writing to request clarification of the application of the Investment Advisers Act of 1940 (the "Advisers Act"), as amended, and the Investment Company Act of 1940 (the "Investment Company Act"), as amended, to the aggregation of orders. We request that the Division of Investment Management confirm that it will not recommend enforcement action if SMC Capital, Inc., a registered investment adviser (the "Applicant"), aggregates orders in the manner described below.

### **I. Facts**

The Applicant provides investment advice to a number of different types of investors, including individual accounts, ERISA accounts, mutual funds, private investment limited partnerships exempt from registration as investment companies under Section 3(c)(1) of the Investment Company Act, and insurance company investment accounts. In several instances where the client advised by the Applicant is not an individual but rather is an investment vehicle -- for example, a registered investment company or a Section 3(c)(1) partnership -- employees and principals of the Applicant are investors in that entity as well.

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It is generally true in the execution of orders in the marketplace that, up to a point, larger orders may be executed at lower commission costs on a per-share and per-dollar basis than smaller orders. In view of the acknowledged duty that any investment adviser has to seek the best possible execution for his client, the Applicant believes it is obligated to seek the lowest possible execution cost for all its clients -- including clients in which employees and/or principals of the Applicant are among the investors -- by engaging in aggregation of orders. In addition, the Applicant believes that if it aggregates orders under the circumstances outlined below, the risk that any particular account would be or could be systematically advantaged (or disadvantaged) would be minimized.

## II. Legal Background

The Commission has addressed the question of aggregation of orders in at least three no-action letters. In Weston Capital Management, Inc., [1977-1978 Transfer Volume] Fed. Sec. L. Rep. (CCH) ¶ 81,408 (Aug. 11, 1977), Weston Capital sought no-action assurance for a proposal to aggregate trades for certain of its advisory clients. In justifying its proposal, Weston Capital emphasized that the aggregation of orders did not mean that accounts were in any way being managed on a pooled basis. Id. at p. 88,874. Weston Capital further proposed to adopt the following six conditions in conducting its order aggregation activity:

1. Weston Capital would not own or trade any securities for its own account.
2. The written approval of clients would be obtained before aggregation of their trades began.
3. Each account would be managed on an individual basis and at the opening of each account Weston Capital would obtain from the client information regarding the client's financial circumstances and objectives.
4. Weston Capital's agreements with its clients would provide that under no circumstances would it obtain direct custody of any client funds or securities.
5. Weston Capital would receive no additional compensation or remuneration of any kind as a result of the proposed procedure.

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6. Aggregation of trades would occur only if trades in the same security were indicated for more than one account at the same time.

Based upon the representations of Weston Capital, the Commission staff granted the request for no-action relief. In particular, the staff wrote:

"[W]e would not recommend that the Commission take action under the Investment Advisers Act of 1940 or the Investment Company Act of 1940 against Weston Capital Management, Inc. ('Adviser') if it aggregates contemporaneous purchase or sell orders of its segregated advisory accounts for the exclusive purpose of achieving lower per share brokerage commission costs for orders provided that (1) the arrangement for aggregation has been disclosed previously to each client for whom an order is aggregated, (2) the Adviser does not breach his duty to act in the individual best interest of each client which duty requires, in part, that no advisory account be favored over any other advisory account and, thus, that each account participate in an aggregated order at the average share price, (3) only the accounts of advisory clients be aggregated, and (4) individual investment advice is provided each account."

*Id.* at p. 88.873. Similar requests for relief have been granted by the staff more recently, with similar conditions, in Piette and Associates, Limited, [1981-1982 Transfer Volume] Fed. Sec. L. Rep. (CCH) ¶ 77,065 (Aug. 18, 1981), and Owen T. Wilkinson & Associates, Inc., [1987-1988 Transfer Volume] Fed. Sec. L. Rep. (CCH) ¶ 78,556 (Feb. 3, 1988).

Although Weston, Piette, and Wilkinson each required, as a condition, that "only the accounts of advisory clients be aggregated," these letters do not offer guidance as to the staff's intended meaning of this limitation. More specifically, these previous no-action letters have not addressed the important question of the point at which investment by an adviser or its affiliates in a vehicle in which unaffiliated persons also have invested becomes so significant that aggregation of client orders should not be permitted. It seems obvious, for example, that where the adviser's ownership is at a low level -- perhaps a one percent interest as general partner of an investment limited partnership -- the partnership should be con-

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sidered to be an "advisory client" of the adviser as that term was used by the staff in Weston.<sup>1/</sup>

### **III. Discussion**

As noted above, the Applicant believes that it can most effectively seek best execution for all its advisory clients if it aggregates orders for advisory clients in the manner that includes advisory client accounts in which affiliated persons of the Applicant have an investment interest. The Applicant therefore seeks the staff's assurance that it would not recommend enforcement action if the Applicant engages in the aggregation of client orders on the following basis:<sup>2/</sup>

1. Policies for aggregation of transactions will be fully disclosed in the Applicant's Form ADV and separately to the Applicant's current clients and the broker/dealers through whom such orders are placed;
2. The policies for aggregation of transactions of any registered investment company will be submitted to and approved by the board of directors of such company;
3. The Applicant shall not aggregate transactions unless it believes such aggregation is consistent with its duty to seek best execution (which shall include best price) for its clients and is consistent with the terms of the Applicant's investment advisory agreements;
4. No advisory account will be favored over any other account; and each account that participates in an aggregated order will participate at the average share price for all transactions of the Applicant in that security on a given business day, with all transaction costs shared on a pro rata basis;

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<sup>1/</sup> Indeed, if such a one percent interest were somehow to "contaminate" the advisory nature of the essential relationship between the adviser and the investment vehicle, no investment partnership could ever have its orders aggregated with those of other clients (since advisers acting as general partners almost invariably have a one percent interest to satisfy certain tax concerns).

<sup>2/</sup> The Applicant is not requesting relief with respect to the following procedures for trades involving privately placed securities. However, Applicant believes that the principles underlying these procedures would apply equally to aggregated trades involving such securities.

5. The Applicant will compose, before entering an aggregated order, a written statement (the "Allocation Statement") as to how the order will be allocated among the various accounts;
6. If the aggregated order is filled in its entirety, it shall be allocated among the accounts in accordance with the Allocation Statement; if the order is partially filled, it shall be allocated pro rata based on the Allocation Statement;
7. Notwithstanding the foregoing, the order may be allocated on a basis different from that specified in the Allocation Statement if all accounts of clients whose orders are allocated receive fair and equitable treatment and the reason for such different allocation is explained in writing and is approved in writing by the Applicant's compliance officer no later than one hour after the opening of the markets on the trading day following the day on which the order is executed;
8. If an aggregated order is partially filled and allocated on a basis different from that specified in the Allocation Statement, no account that is benefited by such different allocation may effect any purchase or sale, for a reasonable period following the execution of the aggregated order, that would result in it receiving or selling more shares than the amount of shares it would have received or sold had the aggregated order been completely filled;
9. The Applicant's books and records will separately reflect, for each account of a client whose orders are aggregated, the securities held by, and bought and sold for, each account;
10. Funds and securities of clients whose orders are aggregated will be deposited with one or more banks or broker-dealers, and neither the clients' cash nor their securities will be held collectively for the clients any longer than is necessary to settle the purchase or sale in question on a delivery versus payment basis; cash or securities held collectively for clients will be delivered out to the bank or broker-dealer having custody of the client's account as soon as practicable following settlement;
11. The Applicant will receive no additional compensation or remuneration of any kind as a result of the proposed procedure; and

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12. Individual investment advice and treatment will be accorded to each advisory client's account.

We believe that permitting aggregation under the foregoing conditions, regardless of the level of the adviser's interest in the transaction, is fully consistent with both the Advisers Act and the Investment Company Act, each of which is addressed separately below.

A. Investment Advisers Act of 1940

The proposal to aggregate orders of wholly non-proprietary accounts and accounts in which employees or principals of an Applicant own some stock or partnership interest implicates a number of duties under the Advisers Act. These duties of the adviser include the duty of disclosure<sup>3/</sup> and the duty to treat each client fairly.<sup>4/</sup> The Applicant's proposed course of action is consistent with each of these duties.

1. *Duty of Disclosure*

The duty of disclosure will be satisfied by conditions #1 and #2 above, which require that the proposal be fully disclosed to clients and specifically approved by clients that are registered investment companies. The disclosure (on Form ADV) will also explain that aggregation should, on average, reduce slightly the costs of execution and that the adviser will not aggregate a client's order if, in a particular instance, it believes that aggregation would cause the client's costs of execution to be increased.

2. *Duty to Treat Each Client Fairly*

The duty to treat each client fairly will be satisfied by conditions #4 through #8 above, which require -- among other things -- that no advisory account be favored by the Adviser over any other account and that each client who participates in an aggregated order will participate at the average share price,<sup>5/</sup> with all transaction costs shared on a pro rata basis. In addition, a policy of permitting aggregation as described in this letter will greatly simplify the policing of an adviser's investment practices as it will be easy to determine

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<sup>3/</sup> See 17 C.F.R. § 275.204-3.

<sup>4/</sup> See, e.g., Wilkinson, supra; see also Piette, supra.

<sup>5/</sup> See Charles Schwab & Co., SEC No-Action Letter, 1990 LEXIS No-Act. 543 (Mar. 13, 1990) (permitting assigning of average price per share to aggregated orders); Dean Witter & Co., SEC No-Action Letter, 1977 LEXIS No-Act. 1836 (Jul. 14, 1977) (same); Kidder, Peabody & Co., SEC No-Action Letter, 1976 LEXIS No-Act. 902 (Apr. 18, 1976) (same).

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whether the policy has been adhered to and whether each client, therefore, has been treated fairly.

On the other hand, precluding aggregation of accounts poses a number of problems. First, precluding aggregation of accounts where advisory personnel own an interest could eliminate or reduce the cost savings that can be obtained from aggregation.

Second, there appears to be only one remote, theoretical conflict of interest that would be avoided if the Applicant were prohibited from aggregating accounts where affiliated persons of an adviser own interests. That is, there might be a concern that aggregation of orders could cause an adviser to purchase unsuitable securities for one client account so as to reduce the execution costs for an account in which advisory employees owned an interest. However, the gains from aggregation in terms of reduced execution costs are highly unlikely to provide incentives to an adviser to acquire unsuitable investments for one client account.

Third, precluding aggregation of accounts in the circumstances proposed above will greatly complicate the adoption and monitoring of policies to prevent conflicts of interest, thereby increasing administrative costs and non-compliance risks to investment advisers whose principals and employees are, to paraphrase, "willing to put their money where their advice is." For example, where an adviser wishes to acquire the same securities for two accounts that cannot be aggregated because one is owned by affiliates, how is the adviser to determine which account's orders get filled first? One possibility is that the order of fill be randomized; another is that the right to go first rotates in a fixed order. In either case, the result would be that the accounts would be deprived of the economies of scale that aggregation allows, and one or more accounts could be inadvertently "front runned." Another policy is one that allocates the best priced orders after the fact to accounts that do not include any advisory personnel and the remainder to the accounts that include advisory personnel. Such a policy, however, would be unfair to the unaffiliated persons who invest in accounts in the latter category (and to whom the Applicant owes fiduciary duties). Such a policy also would likely drive affiliated persons of an adviser to invest wholly independently of the adviser's clients, thereby driving up execution costs for all concerned and reducing the commonality interest between such persons and advisory clients. Indeed, in the recent discussions of personal trading by mutual fund portfolio managers, the statement has been made repeatedly that it is better for portfolio managers to invest with their clients than separately from them.

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In sum, we believe that the proposal above to permit the Applicant to aggregate orders as long as the procedures set forth above are followed is fully consistent with the terms of, and the policies underlying, the Advisers Act.

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B. Investment Company Act of 1940

The aggregation of client orders also raises an issue under the Investment Company Act, because the aggregation of orders of a registered investment company ("RIC") with an affiliate of or underwriter for the RIC, or an affiliate of either, may be a prohibited joint transaction under the Investment Company Act. Section 17(d) of the Investment Company Act and Rule 17d-1 promulgated thereunder generally prohibit an affiliate of or principal underwriter for a RIC, or an affiliate of either, from effecting any transaction in which the RIC, or a company controlled by the RIC, is a "joint or joint and several" participant, without the prior approval of the Commission.<sup>g</sup>

It appears that the Commission currently takes the position that aggregating orders of RICs with orders of their affiliates or affiliates of their affiliates is not a joint transaction. We know of no enforcement action brought by the Commission on the ground that such a transaction was effected without its prior approval, and, in a recent enforcement action brought under Section 17(d), the Commission implied that aggregation alone would not constitute a joint transaction. In 1993, the Commission brought an enforcement action against Kemper Financial Services, Inc. for effecting joint transactions in violation of Section 17(d) and Rule 17d-1.<sup>h</sup> Kemper exercised discretionary authority in aggregating orders for advisory clients, including two mutual funds and a Kemper employee profit-sharing plan. Kemper did not designate the client for which the orders were entered and allocated trades with more favorable execution prices to the profit-sharing plan. The Commission's Order nowhere suggests that the violation of the joint transaction provision arose by virtue of the very fact of aggregation. Rather, the Commission stated that the joint transaction "arose from the manner in which" the trades were allocated, implying that trades may be aggregated between RICs and their affiliates without triggering the joint transaction prohibition if proper allocation procedures are followed.<sup>i</sup> Based on Kemper, we believe that the aggregation of

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<sup>g</sup> 15 U.S.C. § 80a-17(d); 17 C.F.R. § 270.17d-1.

<sup>h</sup> In re Kemper Financial Services, Inc., Administrative Proceeding File No. 3-8207, [1993 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 85,237 (Oct. 20, 1993).

<sup>i</sup> Id. at 84,597 (emphasis added). But see Notice of Proposal to Amend Rule 17d-1 by the Adoption of Rule 17d-1(d)(4), Investment Company Act Release No. 7035, 1972 SEC LEXIS 1485, at \*2-3 (Mar. 9, 1972) ("Section 17(d) . . . and Rule 17d-1 . . . may be deemed to prohibit affiliated persons of, and principal underwriters for, a [RIC] or affiliated person of such persons . . . from combining, for the purpose of execution, their orders for the purchase or sale of securities with an order of such [RIC]."); Notice of Withdrawal of Proposed Rule 17d-1(d)(4), Investment Company Act Release No. 9170, 1976 SEC LEXIS 2376 (Feb. 19, 1976); Douglas Mercer, SEC No-Action Letter, [1971-1972 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 78,662 (Jan. 8, 1972) (permitting aggregation of RIC orders with orders of affiliates under cer-

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orders for RICs, or companies controlled by RICs, with orders of their affiliates does not constitute a joint transaction under Section 17(d) and Rule 17d-1.

Moreover, it is generally accepted that an element of combination, pattern of conduct, or profit motive must be present for Section 17(d) and Rule 17d-1 to apply.<sup>9</sup> The aggregation of orders does not alone constitute a combination or pattern or an enterprise conducted for the purpose of making a profit. The decision to aggregate is not the product of an understanding among the parties to engage in a pattern of behavior; rather, it is merely a discrete incident of independent decisions made by the parties to purchase the same security at the same time. Any "pattern" of aggregating trades among certain entities would result only from a commonality of investment objectives, and not from any motive or purpose related to the execution of the order.

Nor is it necessary to treat the aggregation of orders of RICs and their affiliates as a joint transaction to effect the policies underlying the joint transaction prohibition. As the Commission has stated:

"Section 17(d) and Rule 17d-1, taken together, are designed to enable the Commission to pass upon transactions in which a conflict of interest may result in investment companies or their controlled companies participating on a basis different from or less advantageous than other participants."<sup>10</sup>

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<sup>9</sup>(...continued)

tain conditions pending adoption of proposed Rule 17d-1(d)(4)); Ropes & Gray, SEC No-Action Letter, 1972 LEXIS No-Act. 378 (Jan. 8, 1972) (same).

<sup>10</sup> See Rule 17d-1(c); 17 C.F.R. § 270.17d-1(c) (requiring participation in "enterprise or undertaking" or sharing of profits of same); SEC v. Talley Indust., Inc., [1967-1969 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 92,240, at 97,103 (2d Cir. 1968) ("some element of 'combination' is required" for Section 17(d) to apply), cert. denied, 393 U.S. 1015 (1969); In the Matter of Steadman Security Corp., Investment Company Act Release No. 9830, [1977-1978 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 81,243, at 88,339-13 (June 29, 1977) (requiring a "causal nexus or a quid pro quo" between the relevant transactions in order to prove the necessary element of "some sort of 'combination'" under Section 17(d)); In the Matter of Steadman Security Corp., Administrative Proceeding File No. 3-3101, [1974-1975 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 80,038, at 84,848 (Dec. 20, 1974) (requiring profit motive or element of investment to sustain Section 17(d) violation).

<sup>10</sup> Amendment to Rule 17d-1 Exempts Stock Plans of Controlled Portfolio Companies, Investment Company Act Release No. 6154, [1969-1970 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 77,847, at 84,000 (Aug. 10, 1970). Section 17(d) authorizes the Commission to prescribe rules thereunder "for the purpose of limiting or preventing participation by [a RIC] or controlled company on a basis different from or less advantageous than that" of other participants. 15 U.S.C. § 80a-17(d).

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As discussed above, the aggregation of RIC orders with orders of affiliates would present minimal risk that the RIC -- or any participant -- in the transaction would be treated unfairly. To the contrary, the very purpose of aggregation is to ensure that all parties participate on the same basis, and the risks of unfair treatment would be greater if the orders of RICs were required to be executed separately from orders of non-RICs.

Finally, excluding the aggregation of orders from the joint transaction prohibition would be consistent with positions that the Commission and its staff have taken in analogous situations. In the 1970s, the staff granted no-action relief under Section 17(d) and Rule 17d-1 in connection with the purchase of errors and omissions policies by a RIC and its affiliates.<sup>11/</sup> The parties purchased the insurance on a joint basis in order to obtain bulk discounts on premiums. In 1979, the Commission codified the staff's no-action positions by amending Rule 17d-1 to exempt joint purchases of liability policies by RICs and their affiliates.<sup>12/</sup> Similarly, in 1973 the Commission amended Rule 17g-1 under the Investment Company Act to exempt joint purchases of fidelity bonds by RICs and their affiliates from the joint transaction prohibition.<sup>13/</sup> Thus, the Commission and its staff have previously exempted from the joint transaction prohibition transactions that involve the aggregating of purchases of services by a RIC and affiliated parties for the purpose of obtaining bulk discounts.<sup>14/</sup>

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<sup>11/</sup> See St. Paul Capital Fund, Inc., SEC No-Action Letter [1979 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 82,056 (Mar. 16, 1979); Mathers Fund, Inc., SEC No-Action Letter, [1978 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 81,695 (Feb. 6, 1978); Capital Preservation Fund, Inc., SEC No-Action Letter, [1976-1977 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 81,022 (Nov. 27, 1976); Parthenon Fund, Inc., SEC No-Action Letter, [1975-1976 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 80,451 (Mar. 3, 1976).

<sup>12/</sup> Exemption of Certain Joint Purchases of Liability Insurance Policies, Investment Company Act Release No. 10891, [1979-1980 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 82,317 (Oct. 4, 1979).

<sup>13/</sup> 17 C.F.R. § 275.17g-1; Adoption of Amendments to Rule 17g-1 under the Investment Company Act of 1940 to Provide That Fidelity Bonds Required Pursuant to the Rule Shall Comply with Certain New and Revised Provisions, Investment Company Act Release No. 8267, [1973-1974 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 79,703 (Mar. 14, 1974).

<sup>14/</sup> The Commission has taken the position that, when "there is little likelihood that participation by [a RIC in a transaction] will result in unfair or disadvantageous treatment" to the RIC or companies controlled by the RIC, it is relevant "that the antifraud provisions of the federal securities laws are also applicable to joint transactions in which registered investment companies or their controlled companies participate." Adoption of Amendment to Rule 17d-1 Under the Investment Company Act of 1940 Exempting Certain Joint Transactions Involving Registered Investment Companies, Investment Company Act Release No. 8542 [1974-1975 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 79,982, at 84,528 (Oct. 15, 1974) (amending Rule 17d-1 to exempt certain affiliated transactions from Rule). As discussed above, we believe that the antifraud

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#### **IV. Conclusion**

For all the foregoing reasons, we respectfully request that the staff grant the request for no-action relief set forth above. If you have any questions, please do not hesitate to call me at 202-663-6733 (or, in my absence, please call Mercer E. Bullard at 202-663-6444).

Yours truly,



Eric R. Markus

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<sup>14</sup>(...continued)

provisions of the Advisers Act, and the fiduciary duties imposed thereunder, provide ample protection against the minimal risk of self-dealing presented by the aggregation of orders.