Supreme Court of the United States

OCTOBER TERM, 1970

In the Matter of:

Docket No. 59

pt 1

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,	
Petitioner	
vs.	
SECURITIES AND EXCHANGE COMMISSION, ET AL.,	
Respondents	

Place Washington, D. C.

Date December 15, 1970

ALDERSON REPORTING COMPANY, INC.

300 Seventh Street, S. W.

Washington, D. C.

NA 8-2345

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NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., Petitioner	)	
vs	)	No. 59
SECURITIES AND EXCHANGE COMMISSION, ET AL., Respondents	)	

The above-entitled matter came on for argument at 10:10 o'clock a.m., on Tuesday, December 15, 1970.

BEFORE:

WARREN E. BURGER, Chief Justice
HUGO L. BLACK, Associate Justice
WILLIAM O. DOUGLAS, Associate Justice
JOHN M. HARLAN, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
POTTER STEWART, Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice

APPEARANCES:

ARCHIBALD COX, ESQ.
Cambridge, Massachusetts
On behalf of Respondent
First National City Bank

DANIEL M. FRIEDMAN, Office of
the Solicitor General
Department of Justice
Washington, D. C.
(for the U. S., as amicus curiae,
in support of First National City Bank

aAPPEARANCES (Cont'd)

JOSEPH B. LEVIN, ESQ.
Washington, D. C.
On behalf of Petitioner

P R O C E E D I N G S

MR. COX: Mr. Justice Black, and may it please the Court:

Yesterday I pointed out that since the Federal Reserve Act of 1913, managing other people's monies in various fiduciary capacities has been a traditional banking function, and that the individual managing agency account has been one way of performing that function. It allows testimentary trusts, ??? intervivos trusts, executiveships and the like and other forms of agencies.

In the beginning the Federal Reserve Board followed the common law and forbade national banks to co-mingle the assets of different beneficiaries or different principals. About 1920 it began to relax that rule and in 1937 there came a major relaxation that permitted the co-mingling of the ratings of different trusts, executiveships and guardianships and the like. And under that new regulation the now familiar common trust fund grew and flourished. It is partly, I think, because of the economies of comingling which reduce the management costs and partly because of the advantages of diversification.

Q And that, you say, goes back to 1913?

A Well, the statute goes back to 1913; the comingling was not authorized until about 1920; then on a very small scale and then comingling on the scale that we are now

familiar with for the common trust fund, came in in 1937. But, in 1937 the world was not relaxed so far as individual managing agency accounts wereconnemnadd, which --

Q That is for inter vivos trustees or testimentary trustees --

A Exactly, sir --

Q --that could participate in a comingled fund for --

A Yes. The effects of Regulation 9 which is in issue in the next case is to extend to managing agencies the sole privilege of comingling that have proved so successful and so free from abuse in the case of trusts and that kind of fiduciary capacity.

Indeed, when you come to look at Regulation 9 you will see that it treats comingling strict trust funds and managing agency funds in exactly parallel capacity. Well, the reasons for this were very well stated somewhat later by the Federal Reserve Board in a letter to Congress speaking of the public interest in having banks continue to offer this kind of managing agency comingled investment account, in a letter quoted in the back of our brief on Page 45-A, where it pointed out that there were three advantages: first was a means of performing a traditional banking function while efficiently and at less cost; second that it provided competition to the mutual fund, which of course in these cases,

is seeking to preserve its monopolistic or quasimonopolistic position free from competition. And third, in special cases it enabled a combination of investment and other special fiduciary services.

During the time that Regulation 9 was under consideration, the Securities and Exchange Commission took the position that any comingled fund in managing agency accounts would be subject to the Investment Company Act. It said that the interest in the funds would be securities; that the fund orthe bank would be an issuer or underwriter and that consequently there had to be registration under the Investment Company Act.

I would point out in this connection, however, indeed, emphasize that while the SEC and Chairman Carey and Chairman Cohen, stood very stoutly on the position that th must be conformative with the Investment Company Act, they never took the view that the managing agency comingled investment account was unlawful or in any way against the public interest. Indeed, from the very beginning, as Chairman Carey and later Chairman Cohen and the staff all indicated that they would look favorably at exempting a managing agency comingled investment account from any provisions of the Investment Company Act that might be a bar to performing the functions authorized bythe Comptroller under Regulation 9 and later reported by the Federal Reserve Board.

Q Now, suppose that a single investor, under the 1940 act won't be applicable?

A No; not at all. The 1940 Act would not be applicable to the type of common trust fund involving an inter vivos or testimentary trust because it is expressly exempted.

Q Nor would it be applicable to management -- for a single investor?

A No. That's correct. If we see -- if the SEC said brought it under the Investment Company Act.

Q Wasn't it the issuing of certificates of participation or whatever you call it --

A I believe not, Justice White. I think their position was that even if there were no piece of paper, it would be the interest, the undivided interest would nevertheless be regarded as something that brought them under the Investment Company Act.

That's my understanding of the test matter.

Of course,as we do it, there are those certificates.

Q For a purpose, I suppose?

A For the purpose of carrying -- we say for the purpose of carrying out our fiduciary responsibility and for no other purpose.

There is a controversy between the Comptroller and the Commission which led to Congressional hearings. During

that controversy Citibank developed a plan in which it was believed would comply best with the requirements of the banking laws and be satisfactory to the SEC and the Investment Company Act.

Now, what he contemplated was this: Citibank would continue to receive assets in a fiduciary capacity under the relation of managing agent and principal with all the fiduciary duties, or with discretion toinvest those through a common fund. To the extent necessary to comply with the Investment Company Act the common fund or account, as it came to be called, was given a separate structure. The principals, the customer investors, were given certificates of participation which were non-assignable, non-transferable, which would terminate upon their death.

The certificate holders were given the right to choose as they wished a committee made up of five individuals, as it developed; two of whom were not required to be connected with the bank. And the committee of participants were given power to terminate the bank investment advisory contract at any time at the end of the year, subject, however, to the possibility of that adverse role.

The bank has custody of all of the assets; as managers, attends to them in every way; chooses what investments to make and so forth. So that inthe ordinary day-to-day operation the whole thing is carried out by the bank, subject

only to this possibility of the certificate holders exercising common control to kick the bank out.

There are a few other minor departures. They are outlined in our brief in footnote 12. None of them, I think, affect the theory or the fiduciary relation; certainly none effect the individual fiduciary relation between the bank and the customer investors, the principals, and the bank continues to be required to conform in all respects, except those I have mentioned and the other details to the provisions of Regulation 9.

Now, from the standpoint of the banking laws, it seemed important that all these activities be conducted, as the Federal Reserve Board later put it, as an arm or department of the bank, as one of many functions within the trust department of the bank. And, while the investment advisor's contract alone might be enough to do that, it seemed advisable to the bank and its lawyers that a majority of the board of directors should also be officers of the bank. And it was that that led to the application for an exemption from Section 10-C, which provides that a bank may not have a majority of the board of directors of an investment company.

When the matter came before the SEC it made three critical findings. The first, on page 60 points out that this account which is technically an investment company --

Q Page 60 of the record?

A Page 60 of the Appendix; yes.

It pointed out that this was not the kind of investment company at which Section 10(c) appeared to be aimed. Although Section 10(c) is general in terms it does not appear that it was directed at the type of open-ended investment company represented by the account.

Then, skipping a few sentences: "It is clear that the account is substantially different, both in purpose and in nature of operation from the bank-dominated investment companies which led to passage of the act."

The second finding is over on page 62: "In our opinion," the Commission said, "the bank has shown that substantial safeguards are present here against conflicts of interest which could arise as a result of the bank's commercial banking activities."

And the third finding, which is implicit, is that "The exemption to permit these activities to go forward would be in the public interest."

We submit first, in our legal argument, that if these findings are reasonable -- these conclusions are reasonable, then the Commission's order is plainly valid. Section 6(c) of the statute, which is on the bank of our brief on Page 7-A, plainly gives the Commission power to exempt any person conditionally or unconditionally from any provision or provisions of this title. Surely the words "any provision or provisions

of this title," are broad enough to encompass the provisions of Section 10(c). Now, the fact that literally the bank -- the account falls within Section 10(c) does not defeat the power to exempt, because of course, the mere purpose of the power to exempt is to take care of cases which literally fall within the language of the statute.

And furthermore, that has been the consistent interpretation of Section 10(c) for 28 years. It was explained to Congress when Section 10(c) was pending before it in 1940 that the aim was to take care of cases which had not been foreseen by the draftsmen, which might fall within the literal language of the statute, but in the judgment of the Commission, not really within its policy or sphere.

Now, at the time Section 10(c) was before Congress, there was no comingling of managing agency accounts. Common trust funds, the nearest analogue, were exempted from the Investment Company Act. Consequently, I suggest, that if the Commission's findings are reasonable, then this is the type of case for an exemption.

The Commission's findings that the proposed relationship between Citibank and the account is not the kind addressed by Section 10(c), seems to me to be supported by five considerations. First, the type of investment with which Congress was concerned in 1940, when it was debating Section 10(c), was a closed end investment company, a fixed pool of securities,

which bank insiders(?) were selling very largely in the hope of making their own profit in a company in which they certainly had an interest.

Now, this account, of course, is wholly the property of the customers, the principals; it's run solely for their benefit and the bank gets nothing more from it than the usual fee that it gets for any fiduciary service; a fee subject to the Comptroller of the Currency.

Second, those investment companies, for the most part, purported to be independent concerns. When the customer -- not the customer, when the investor bought a share he thought he was buying a share of the investment company and if the bank, through its control over the directors, dominated it, he wasn't getting something free from the influence of the bank. He, of course, when he goes to the bank and opens his managing agency account, what he is looking for is the bank's services and what he gets, subject to his power of ultimate control, is the bank services throughout the entire enterprise.

Third, I would emphasize that there is, in this instance, but not in the kind of investment company which Section 10(c) is concerned, a direct fiduciary relation between the bank and the individual customer-investor.

Q Mr. Cox, what is the governing law -- what would be the governing law as between the bank and the people who were investing in this fund or giving their money to the

bank for --

A Well, it would be the common law, I presume, of New York, and that would be backed up by the regulations of the Comptroller of the Currency in Regulation 9, which spell out many of the duties, and of course, the Comptroller annually inspects the fund, as he does other banking activities or if not always quite that often --

Q Well, what -- just out of curiosity, what would restrict the bank from using the funds of its customers in this fund, for banking purposes. Could they invest this money in commercial loans?

A Oh, no, no; they are rigidly forbidden by Regulation 9 and also by the Investment Company Act, to have any dealings with the account.

Q Right. Any investments they make are with outsiders?

A Any investments must be outside. They may make no loans to the account. They may have no interest in the securities that the account acquires or indeed, Regulation 9 even would restrict the bank from buying securities of companies to which it has made a shaky loan, where that would be a breach of trust. And the Comptroller's representatives have been instructed to be on the lookout for such things in the instructions we have quoted in our brief.

I would emphasize that this direct fiduciary

relationship was noted by the District Court in the RCI case. It's spelled out in the _____ affidavit, the executive vice president of the bank, in the RCI case and is also noted by the Court of Appeals and the SEC.

A fourth difference between the investment company at which Section 10(c) is directed and the account, is of course, that the Securities Affiliates and the Associated Investment Company at which Section 10(c) is directed, is set up for the purpose of evading the banking laws and getting out from under the scrutiny of the Comptroller. I perhaps shouldn't say, "evade;" I don't mean that there was any deceit about it. Whereas, all of these activities are carried on, as I said a moment ago, constantly under the control of the Comptroller.

The result is, from those four differences, that none of the evils which were pointed to during the investigation of the bank securities affiliates and bank dominated investment companies, are possible under the present setup. Indeed, not even the Petitioners argue that they are.

Mr. Levin argues that the SEC findings are immaterial, because Section 10(c) imposes a rigid barrier to the bank ever having a majority on the board of directors, where there is any possible conflict of interest. Even so, it's found that this is not the kind of thing that 10(c) is directed at, even though the Commission finds that there are

adequate safeguards and even though the Commission finds that the existence of the account is in the public interest.

I submit that that argument is unsupportable for four reasons: first, it simply contrary to the plain words of Section 6(c) which give power to invest without restriction, except for the necessary fundings.

Second, and very important, the characteristics of the account, or the relationship between the bank and the account, it is said to give rise to the danger of abuse here, are characteristics that are attendant upon all fiduciary banking functions. And we know that Congress didn't find them so dangerous as to prohibit this kind of relationship, because it authorized such fiduciary banking functions in Section 11(k) of the Federal Reserve Act, now Title XII, Section 92(a).

It would certainly be incongruous if Congress somehow had singled out this one special form of activity which is just like the others so far as any of these problems are concerned, and forbidden in -- especially since in this case one has not only the usual safeguards of the fiduciary relationship in the Comptroller's supervision, but it now has the additional safeguard of the Investment Company Act.

We have outlined in our brief a number of indications, as the Commission did in its opinion, that the Congress was not seeking such a rigid separation between banks and investment companies as Mr. Levin argues. There is a

grandfather clause in Section 10(c): banks are allowed to act as investment advisors which, from a day-to-day point of view, is the really controlling manager of the investment company, and because, and we lay great strength on this, the one form of comingling that was known at the time the Investment Company Act was adopted, the Common Trust Fund, was exempted from the Investment Company Act and even part of the analogue(?) even though the Commission said we couldn't bring ourselves within it.

Now, the remaining question is whether thereis adequate support for the SEC findings that the very adequate safeguards against abuse of the bank's control over the fund to the detriment of investors. The Commission took up, point by point, all the abuses which it was said might result and found that they were not sufficiently serious and that there were adequate safeguards against them.

Judge Bazelon took not quite that point. The same arguments were made to the Comptroller and he rejected them. The Federal Reserve Board scrutinized most of them, in the letter that is set forth at the end of our brief and it concluded, too, that there were adequate safeguards and that the existence of such funds would be in the public interest. Consequently, we submit that the Commission findings are reasonably based in the record and that it's order should therefore be affirmed and the judgment of the Court below,

affirmed.

ORAL ARGUMENT BY DANIEL M. FRIEDMAN, OFFICE OF THE SOLICITOR GENERAL, FOR THE U. S., AS AMICUS CURIAE, IN SUPPORT OF FIRST NATIONAL CITY BANK

MR. FRIEDMAN: Mr. Justice Black, and may it please the Court:

At the outset I would just like to explain, in view of the somewhat unusual posture of this case, that the Commission is not appearing here in defense of its order, one: why the United States is appearing in this case; and secondly, why we think that the Commission's position in this case does not undermine the validity of its decision.

As has been indicated, when the Commission granted this exemption in 1966, the result was 4 to 1, with a strong dissent against the granting of the exemption by Commissioner Budge. The Commission vigorously defended its order early in 1967 before the Court of Appeals and that Court unanimously upheld the order.

Now, by the time the case reached this Court, however, and this Court had granted the petition, there had been a significant change in the membership of the Commission. Three of the five commissioners who had originally participated in the case were no longer on the Commission and of the remaining two, one, Mr. Bradford(?) by that time had become

Chairman and voted against the exemption. The other Commissioner had voted in favor.

Now, it was in that posture that the Commission advised the Solicitor General in June of 1970 that it was taking no position in this case. This is the statements that Mr. Levin read to the Court yesterday from page 3 of the Government's brief. Now, this -- I would just like to reiterate two of the sentences that the Commission included in its statement. The Commission said, "The three subsequently appointed members of the Commission are not prepared to take any position," this was after the Commission had pointed out that there were only two remaining members and one was -- had voted for and one had voted against the exemption.

Accordingly, the Commission expresses no position on the merits and urges no offense nor reversal of the judgment of the Court of Appeals. Now, recent written -- in effect, the Commission has said to us in this case is that it is not able at this time to muster a quorum to decide what position to take in this case. Only two members of the Commission at that point were prepared to vote on what to say.

We strongly disagree with Mr. Levin's characterization of the Commission's action yesterday as if the Commission had disavowed its decision. The Commission has not disavowed its decision.

If I may just mix in athletic metaphors for a moment

The Commission in this case, contrary to Petitioner's suggestion, has not thrown in the towel in this case; it is merely sitting this one out on the sidelines.

Q I don't have it in front of me, but the -- something to the effect that it's possible or maybe even likely that if the Commission were dealing with this problem now it would not reach the same conclusions?

A Well, for --

Q I don't have this in front of me --

A Yes. Well, there is no assurance that the Commission would reach the same judgment, if a similar matter is againpresented. I think thatmerely is a rather briefer statement than what was cited in the original brief. As of that time the Commission didn't know what its position would be because only two of the original Commissioners were then available.

But, I want to say that the Commissionhas not disavowed its decision and it seems to us that basically that the validity of the Commission action must be determined on what happened when it acted; not on the basis of the fact that sometime thereafter there had been changes in the membership of the agency and that the present membership is not prepared now to state what position it would take if the issue came before it.

And there was another change in the offering of the

Commission which -- we talk about shifts in membership -- that Chairman Budge, who was the lone dissenter, has announced his retirement, so that presumably by the time this case gets back to the Commission there will only be one of the original Commissioners and we think that the Commission by definition, is a continuing body; it continues as an entity without regard to changes in the emembership and that if the Commission's action was valid when it was taken, it should be upheld even though changes in the body since that time might suggest that if the Commission were to consider it anew the Commission might come out the other way.

The Commission in this case has not asked this Court to remand the case for it to take another look at the case and I think the reason it hasn't done that is again the same reason: that there is no majority ofthe Commission that is prepared to take any position at this time.

So that in these circumstances --

Q Did the Solicitor General ask --

A In this case you mean?

Q Yes.

A No, Mr. Justice, we remarked that we came into the case because it was our belief that in view of the importance of this issue and in view of the fact that the Court of Appeals had unanimously upheld the Commission's order, we feel it was not appropriate that the validity of the

order should just be defended by the bank, which had received the exemption. We felt there is an interest in this and in addition to that, although we haven't set it forth in our brief, the Government, the Solicitor General representing all Government agencies, has an interest in the basic legal issue here, which is the scope of judicial review of an agency on granting an exemption, a question that this Court has not directly dealt with, as far as I know.

So, this is the background as to why we think it was appropriate to give weight to the discretion of the Commission in this case even though the Commission is not here appearing in defense of its order, I would like to turn briefly to the merits, which Mr. Cox has fully covered, and why we think in this case the Commission clearly has not abused its discretion.

The statute under which the Commission has entered this exemption, Section 6(c) gives the Commission authority in the broadest possible terms that allows it to exempt any persons, any transactions, or any class of persons from any provision of the statute. It couldn't be broader. And there is certainly nothing in that sweeping language that in any way suggests that Section 10 of the act is not within the Commission's power to exempt.

What we think Congress is obviously contemplating by this section is that the Commission shall have authority

to exempt any transaction, any person, any security within its terms, if a particular fund for which exemption is sought comes within these public interest factors that are listed as the conditions for the exemption. That is: if the exemption is necessarily appropriate in the public interest, consistent with the protection of investors and the purposes fully intended by the policy and provisions of the act.

Now, the determination, the weighing of these many factors that make up this broad public interest standard, is of necessity something that calls for very difficult, close and subtle factors of balancing, of judgment. This is not the kind of thing that is capable of precise measurement exactly. You can't take a yardstick and say whether it reaches a certain point and therefore is or is not consistent with the public interest.

The granting of an exemption, the decision of whether or not the public interest standards are met in this kind of a case is where the essence of administrative discretion -- it's the kind of thing that necessarily has to be within the discretion of khe agency.

And we have developed in our brief, and as Mr. Cox has indicated at some length, the Commission certainly in this case did not abuse its discretion. The basic evils at which Section 10(c) was directed are not the evils present here. Section 10(c) was put into the act because of a lot of abuses

that had been shown to have taken place in the 1920s in the way in which the banks operated these investment affiliates. What the banks were doing, they were using the investment affiliates as methods of speculating in the securities market and they were unloading on the investment companies a lot of these speculative securities.

Q I think I understood Mr. Cox to say that in answer to that question of Mr. Justice White's, that the bank, and perhaps I didn't hear it correctly, could not make a loan to one of these accounts?

A No. The bank could not make a loan to the account or the fund. That is right, but there are several reasons for this. First --

Q I know, but what's the significance, then of 18(a) of Mr. Cox's brief of Section 3(f)? "A national bank may make a loan to an account; they may take the security there for assets of the account, provided such transaction is fair to such account and is not prohibited by local law.

A 18 --

Q 18(a) of Mr. Cox's brief of July 18th -- th there are two briefs here, one for December and the other of July.

A Well, I assume that that is basically and is for someshort term basis or something like that.

Q But it was -- this does say that under the

conditions set out the bank may make a loan to --

A Mr. Justice, if I may retract my statement, I have been informed that relates to an individual account.

Q It does not deal with these cases?

A It does not deal with this type of account. That is what the Comptroller's man has informed me.

If I may explain several things --

Q I thought Mr. Cox had said that Regulation 9 had governed the relationship between the bank and the account we have before us.

A Regulation 9 broadly governs all fiduciary activities of banks. It's Regulation 9.18 which specifically deals with comingled accounts. This Regulation 9 is the general regulation which affects the bank's control and operation of fiduciary activities.

Q Well, except for 9.18, then are you telling us that none of the rest of Regulation 9 printed here as I suggest --

A No, I'm not. I'm saying that Regulation 9 general governs the bank's fiduciary operations and to whatever extent it's covered by Regulation 9 generally, of course, it's applicable. Then, in addition to that the Comptroller promulgates special regulations dealing with comingled accounts, which is 9.18, which imposes certain obligations --

Q And 9.18 is more restrictive on what the bank

can --

A Oh, yes; marketing --

Q -- than is 9.11?

A I would think so. 9.18, if I may point out a couple of things: first of all, 9.18 specifically prohibits the bank from having any interest in the account and in addition to that, the account's own prospectus states that it will not borrow any money at all; and finally, that provisions of the Investment Company Act which specifically prohibit transactions between affiliates. So, Section 17 of the Investment Company Act would prohibit the bank from selling securities or loaning money to the account.

Q Well, just one more question: I understand that in the provision of 9:12(a) at page 17-A, that this is still another one -- "unless lawfully authorized by the instrument creating the relationship, or by court order or by local law, funds held by a national bank as fiduciary shall not be invested," and so forth, which means that if they were lawfully authorized by the instrument creating a relationship, they could be invested in property acquired from the bank, its directors, and so forth?

A Yes.

Q You are telling me that this does not apply to this kind of account; is that it?

A It does not apply, Mr. Justice, for one

reason, which is that the arrangement between the participant and the bank does not permit this and in addition to that, the whole --

Q Yes, but that provision says "unless authorized by the instrument."

A But 9.18, in turn, has prohibitions against the bank --

Q Where in 9.18 is a prohibition against inclusion of a provision under 9.12 in the instrument creating the account? Where's that?

A I'm afraid I don't have 9.18 in my brief in the --

Q Well, at page 21-A of Mr. Cox's brief.

A Section --

Q 9.18, collective investments. I doubt if Mr. Cox has given us the full text of Regulation 9.

A I believe it's -- it's Section 9.18(b)8(i). Now, let me see if I can find that in Mr. Cox's brief.

Yes, it's on page 25-A of Mr. Cox's brief at paragraph a, and it says: "A bank administering a collective investment fund shall not have: (a) any interest in such fund other than in a fiduciary capacity; or (b) make any loans on the security of a participation in such funds," so it prohibits the bank from having any interest in the fund except in a fiduciary capacity. That is that the bank itself -- if it

the bank itself had some money from one of its personal trust accounts, it could invest that in the account.

Q Do you think those provisions on their face, proscribe a national bank making a loan to one of these collective funds?

A Yes, I think it does, because it says "have an interest in the fund," and in addition to that, the prospectus of the fund says that the comingled account will not borrow any money. So that as far as --

Q Anybody.

A Pardon?

Q From anybody.

A From anybody; that's right. The account is to be operated with the money that the participants have put into the account.

Q Where is there any express provision saying that they won't sell -- can't sell any properties to the fund?

A Well, specifically, in Section 17 of the Investment Company Act. Section 17 of the Investment Company Act prohibits transactions between affiliates, and under the terms of the Investment Company Act the bank and the fund are affiliates, so that there is an absolute bar in that section.

In addition to that, I think the provision saying that the bank shall not have any interest in the fund --

Q Prohibits a sale?

A Well, there are -- prohibits a sale -- we are speaking, I take it of the security sale, if the bank were to sell a security?

Q Well, let's assume the bank has the portfolio of loans of real estate mortgages that it would like to market and clean up some of its firms, and they are very good real estate mortgages. And certainly they could sell them to a mortgage company or something. May they sell them to the funds or as a perfectly good investment of the fund in real estate?

A Well, that again, would depend on the circumstances. There is a provision of the Comptroller's regulation Section 9.12 here in the record -- it's called "self dealin " and it says --

Q I know, but you said that doesn't apply.

A No, I did not say that does not apply. I'm sorry, Mr. Justice --

Q All the instrument would have to do is to authorize it and the bank may transfer property to the fund.

A If those sections might affect the exercise of the best judgment -- if the instrument authorizes, but these instruments do not authorize it.

For instance --

Q Well, there is not any prohibition against the instrument authorizing it?

A Well, that again -- that would have to again be submitted to the Comptroller. The Comptroller would have to --

Q Well, here's the regulation. Now, is there or isn't there any provision against the bank selling property to a fund?

A I don't know of any specific provision in those circumstances --

Q That's what I thought.

A -- other than the fact that the bank cannot make any investment have any interest in the fund.

Q Mr. Friedman, do you know whether New York has statutes which many states do which specifically prohibit self-dealing?

A I don't know, Mr. Justice, but I assume that New York, being a very enlightened state, does.

Q Well, I think there are some states more enlightened in the investment field than even New York.

(Laughter)

Other states do have, either by court decision, common law, or by specific statutes and I would be surprised if it were not present somewhere in the New York statutes.

A I think that the whole question of self-dealing is another problem in this, which is the bank is a fiduciary in its relationship with the participants in the

account. And if what the bank does, if it should sell something to the account in a way that violated its fiduciary obligations, I would think that the bank would run afoul of that. And of course, the Comptroller is constantly inspecting these banks; inspecting three times every two years. Its trust department inspects the account of the bank and as a result of which if they saw any existence of this self-dealing, it seems to me it could be quickly corrected.

So that on balance, as I say, we think that this is an area within the Commission's discretion and that the Commission has not abused its discretion in granting the exemption here.

REBUTTAL ARGUMENT OF JOSEPH B. LEVIN, ESQ.

ON BEHALF OF PETITIONER

MR. LEVIN: Mr. Justice Black, and may it please the Court:

I wanted to qualify a response that I gave yesterday in connection with a question Mr. Justice Harlan directed with respect to the Commission's use of Section 6(c). I said that the -- that exemptive authority was used frequently and it is, but I did not mean that it was used frequently in connection with Section 10(c).

The Commission has used Section 6(c) in two cases, both on the same day back in 1969. It was an unopposed order and there was no opinion, but the -- in those cases, in one of

them the order was sought of the investment company and it was not an open-end investment company, garden variety investment company of the kind that we have in this situation, but rather a small business investment company. It's a special arrangement designed to facilitate loans to small business concerns.

In one of the cases all of the stock of the small business investment company is owned by the bank itself. In the other case the stock was owned by the bank and by a trustee for the benefit of stockholders. And the recitals in those paticular orders, and in both orders there was the same recital, and the recital is that: The applicant investment company believes it's entitled to the exemption, and I quote:

"In view of the fact that the public investor interest in applicant investment company is confined to the shareholders of the bank." So that there we have the very much different situation than we have here, because you don't have the potential conflicts of interest between the bank and the investment company.

Now, in terms of the scope of the statute, I simply want to make it clear that the type of relationship, the comingled agency account, is a relationship that is very specifically reached by the statute. The legislative history refers to the situation of the comingled agency account -- it's not a bank-sponsored account. But there was a situation that

specifically referred to in the legislative history, of where certain people had deposited money on an agency basis with an individual and that individual managed the money. He pooled it and the legislative history treats that particular comingled managed agency account as the investment company. Indeed, the Commission, in its report to the Congress in the first volume of the Investment Trust Study, Part 1 on page 24, in talking of the types of relationships which give rise to the investment company, refers to the corporate form for the Massachusetts Trust to the joint stock company and lastly to the agency relationship and I would rather quote from that report a brief passage which indicates what the Commission was thinking about.

"Another distinctive form of organization of investment companies involves an agency relationship between the individual contributors to the fund and the management upon whom they confer substantially the power of attorney to act as agent in the investment of the monies contributed. The group of individuals is not a legal entity, but rather constitutes, in essence, a combination of distinct individual interests."

Now, the problem of the comingled account and, as I say, not in terms of the bank, but the general concept of the comingled account is considered in considerable detail in the Commission's opinion in the Prudential case, which was affirmed

by the Third Circuit. The citation is in our brief and is a full explanation of that particular aspect of the Investment Company Act.

Now, with respect to the exemptions from the common trust fund that have been referred to here: the Commission itself in this very Prudential case that I just referred to, and indeed the Third Circuit adopted the very language of the Commission. The Commission said the following; it referring to the Congress:

"rested this exemption on the special considerations that the funds were used for bona fide fiduciary purposes, rather than submitting for general public investment and had only a limited impact in the investment fund picture." And the Commission did prepare a, as part of this investment trust study, did prepare a special small volume, pamphlet, dealing with the matter of the common trust fund.

Now, [illegible] of you will remember that the Commission did not make any extensive study of the trust fund, and didn't investigate into the matter of the abuses that were involved in the operation of the common trust fund.

Q You mean at the time of the consideration of the bill that became the 1940 act?

A That's right. And the Commission pointed out that one of the reasons for it was that at that time there were, all told, some 16 common trust funds in the country and

the aggregate that they represented was, I believe, about $36 million. There was nothing of consequence in terms of the common trust fund.

Now, the Commission pointed out in that report that the participation in the fund, and I'm quoting now, "in the common trust fund, is not available to the general public," and indeed, the Commission at that time in providing the exemption for the common trust fund, had before it the regulations of the Federal Reserve Board with reference to the common trust funds and and then the specifica provisions in the regulations of the common trust fund, at that time it does appear in the appendix to the Commission's study on the comingled trust account.

The regulations refer to the fact that a common trust fund is a fund maintained by a national bank exclusively for the collective investment or reinvestment of monies contributed thereto by the bank in its capacity as trustee, exceutor, administrator or guardian.

And then it goes on to say, and this is its particular significance: "The purpose of this section is to permit the use of common trust funds as defined in Section 169 of the Revenue Act of 1936, for the investment of funds held by true fiduciary purposes."

And then it goes on: "And the operation of such common trust funds as investment trusts for other than strictly

fiduciary purposes is forbidden."

Q I don't understand the point that it is not available to the general public. It is just as available as a mutual fund is. If you have $25,000 you can buy the trust instrument, an inter vivos trust and then turn it over to the bank as trustee, and it's just as available to the man with $10,000 as is an open-ended --

A Well, the Federal Reserve Board, prior to 1963 when it administered the regulations with respect to the common trust fund, said that you could not use the common trust fund by the device of an inter vivos trust in order to get participation in this common trust and you couldn't use it as a means, in effect, for public participation in a pool of securities. You couldn't use it for the very purpose that the comingled account is being used.

In other words, when --

Q The bank couldn't use it as a trustee under an inter vivos trust?

A It could not be used, and let me put it this way, that the common trust fund could not be used as a means for soliciting public participation in the pool of securities for public investment through the guise?of an inter vivos trust.

Q The bank couldn't --

A That's right.

Q couldn't take solicitation of it, but it certainly was just as available if John Smith has $10,000. He could just as well make an inter vivos trust and turn it over to a bank to be invested by the bank as trustee in the common trust fund as he could go out and buy shares in an open-ended investment --

A He could use the trust relationship to create the trust, but as I say, the terms of the scope of the regulations as it was administered by the Federal Reserve Board was that the trust relationship is not to be used as it is being used here -- actually it isn't a trust relatinship -- here it is called a comingled account -- where, in effect, you provide and create a common package of securities for all comers to come in an make an investment in what is a mutual fund

And the Federal Reserve Board, as it administered the common trust fund provisions, said that if you do have an individualized relationship, the kind of thing that you have in a trust relationship, then you can pool it. But you cannot go out and create an investment company and use the common trust fund as a device to solicit for public participations which is precisely what has been created here and it is for that very reason that the Commission said that it is subject to the Investment Company Act.

MR. JUSTICE BLACK: Is that all of the argument?

(Whereupon, the argument in the above-entitled matter was concluded at 11:00 o'clock a.m.)