

**In the Matters of DELAWARE MANAGEMENT COMPANY, INC.**

**Securities Exchange Act Release No. 8128  
Securities Act Release No. 4875**

**Administrative Proceeding File No. 3-1004**

**UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION  
July 19, 1967**

**FINDINGS AND OPINION OF THE COMMISSION**

**In the Matters of DELAWARE MANAGEMENT COMPANY, INC.  
Seven Penn Center Plaza  
Philadelphia, Pennsylvania  
File No. 8-348**

**W. LINTON NELSON  
JAMES P. SCHELLENGER  
R. WALLACE BOWMAN  
ARNOLD M. GANZ**

**MUTUAL FUNDS ASSOCIATES, INC.  
Two Penn Center Plaza  
Philadelphia, Pennsylvania  
File No. 8-8517**

**MARTIN MALLIN  
MAX FISCHER**

**Securities Exchange Act of 1934 – Sections 15(b) and 15A**

**In the Matter of The Registration Statement of DELAWARE FUND, INC.  
Seven Penn Center Plaza  
Philadelphia, Pennsylvania  
File No. 2-10765  
Securities Act of 1933 – Section 8(d)**

**In the Matter of The Registration Statement of DECATUR INCOME FUND, INC.  
Seven Penn Center Plaza  
Philadelphia, Pennsylvania  
File No. 2-13017  
Securities Act of 1933 – Sections 8(c) and 8(d)**

**BROKER-DEALER PROCEEDINGS**

**Grounds for Suspension of Registration  
Grounds for Suspension from Association with Broker-Dealer  
    Interpositioning  
    Failure to Execute Transaction at Best Price  
    Fraudulent Representations in Offer and Sale of Mutual Fund Shares**

Where registered broker-dealer, which was investment adviser to and principal underwriter for open-end investment Funds, in placement of orders for purchase and sale of portfolio securities on

behalf of Funds caused them to incur unnecessary brokerage costs and charges by interposing broker-dealer, which was substantial dealer in Funds' shares, between Funds and best market; caused sale of portfolio securities, at less than available price, through broker-dealer which supplied research services to investment adviser; and, in offer and sale of Funds' share, used prospectuses which represented that funds sought most favorable prices and executions of orders for transactions in portfolio securities, HELD, registrant and its principal officers willfully violated anti-fraud provisions of Securities Act of 1933 and Securities Exchange Act of 1934, and such officers caused willful violations by registrant of anti-fraud provisions of Investment Advisers Act of 1940, and, under all the circumstances, including registrant's reimbursement of Funds' excess costs and loss on portfolio transactions, in public interest to suspend registrant's broker-dealer registration and suspend officers from association with broker-dealer.

Where registered broker-dealer, which was not a market maker in any securities but was substantial dealer in investment Funds' shares, participated with Funds' investment advisers in arrangement under which registrant was interposed in executing orders for purchase and sale of portfolio securities on behalf of Funds, thereby causing Funds to incur unnecessary brokerage costs and charges; and registrant, in offer and sale of Funds' shares, used prospectuses which represented that Funds sought most favorable executions of orders for transactions in portfolio securities, HELD, willful violations by registrant and its principal officers of anti-fraud provisions of Securities Act of 1933 and Securities Exchange Act of 1934, and in public interest to suspend registrant's broker-dealer registration and suspend officers from association with broker-dealer.

## **STOP ORDER PROCEEDINGS**

### **False and Misleading Statements**

Where registration statements as amended, filed under Securities Act of 1933 by open-end investment companies, contained materially false and misleading statements that it was practice of Funds to seek most favorable prices and executions of orders for transactions in portfolio securities, HELD, stop orders issued suspending effectiveness of registration statements.

### **APPEARANCES:**

Paul F. Leonard and Alan Steinberg, of the Washington Regional Office of the Commission, and Robert J. Routier, for the Divisions of Trading and Markets and Corporate Regulations.

Fred C. Aldridge, Jr., of Stradley, Ronon, Stevens and young, for Delaware Management Company, Inc., W. Linton Nelson, James P. Schellenger, R. Wallace Bowman, and Arnold M. Ganz.

Thomas G. Meeker and J. Gordon Cooney, of Schnader, Harrison, Segal and Lewis, and Jay H. Eiseman, of Barba and Eiseman (of counsel). For Mutual Funds Associates Inc., Martin Mallin and Max Fischer.

Henry T. Reath and Thomas R. Bevan, of Duane, Morris and Heckscher, for Delaware Fund, Inc., and Decatur Income Fund, Inc.

On May 1, 1967, in consolidated proceedings, we issued orders pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") which suspended the registrations as brokers and dealers of Delaware Management Company, inc., ("Management") and Mutual Funds Associates, Inc. ("Associates") for periods of 45 days and 15 business days, respectively. We also suspended from association with any broker or dealer, W. Linton Nelson, president of Management, James P. Schellenger, a vice-president, R. Wallace Bowman, investment vice-president, and Arnold M. Ganz who succeeded Bowman as investment vice-president, for 60 days, 30 days, 30 days, and 10 days, respectively, and Martin Mallin, president of Associates, and Max Fischer, its secretary-treasurer, for 15 business days. 1/ In addition, we issued orders pursuant to Section 8(d) of the Securities Act of 1933 suspending the effectiveness of registration statements, as amended, filed

by Delaware Fund, Inc. ("Delaware") and Decatur Income Fund, Inc. ("Decatur"), registered open-end investment companies, and denying effectiveness to a certain post-effective amendments, as amended, filed by Decatur. 2/

Management is the investment advisers to and principal underwriter for Delaware and Decatur, and its officers hold or help corresponding positions in those companies. Such officers were vested by the Funds with the executive and supervisory responsibility for conducting the affairs of the Funds, which responsibility embraced but was not limited to the direction of their day-to-day operations, including the selection of portfolio securities for purchase and sale pursuant to the Funds' stated investment policies, and the placement of orders for the purchase and sale of such portfolio securities. Associates is a dealer in the shares of the two Funds and executed portfolio transactions for them on a continuous and regular basis.

Our orders were entered pursuant to offers of settlement and upon consideration of the record as stipulated by the parties. Under those offers, the Management respondents, solely for the purpose of these proceedings, admitted and consented to certain findings of fact and violations of anti-fraud provisions of the Securities Act, the Exchange Act and the Investment Advisers Act of 1940 ("Advisers Act") and to such inferences and conclusions as we might deem appropriate. The Associates respondents, solely for the purpose of these proceedings and without admitting or denying violations of anti-fraud provisions of the securities acts, admitted and consented to certain findings of fact and to such inferences and conclusions as we might deem appropriate. Delaware and Decatur, for purposes of these proceedings only, admitted and consented to findings that their registration statements which became effective under the Securities Act of April 23, 1954 and March 14, 1957, respectively, as amended by certain post-effective amendments filed between 1962 and 1966, contained materially false and misleading statements, Decatur further admitted and consented to a finding that a certain post-effective amendment as amended, filed in 1967, which had not been declared effective, was also materially incomplete and inaccurate. In addition, the Funds admitted and consented to the findings set forth in Management's offer of settlement and to such inferences and conclusions as might be drawn therefrom. In accordance with those orders, we now issue our detailed findings and opinion.

The Funds admittedly were in a position, in substantially all instances, to deal directly with the same broker-dealers used by Associates in executing over-the-counter portfolio transactions for the Funds, on as favorable a basis as Associates without incurring the brokerage costs and charges charged to them by Associates. The Funds maintained a joint trading department consisting of two traders and other administrative personnel, 5/ and had direct telephone wires to various broker-dealers who were market makers or specialists in large blocks of securities. 6/ In some instances, the Funds in fact did trade in both listed and unlisted portfolio securities in the over-the-counter market directly with such broker-dealers. These instances included transactions in portfolio securities in which they also effected transactions through Associates.

It is clear that the officers of the Funds had a fiduciary responsibility to the Funds and their shareholders to seek the most favorable execution of portfolio transactions. In handling the Funds' portfolio transactions those officers, who as stated were also Management's officers, disregarded that responsibility by engaging in the practice of interposing Associates between the Funds and the best market. Moreover, Management, which undertook the placement of portfolio transactions for the Funds, violated its own responsibility to the Funds to secure the best execution. Associates was interposed, in order to compensate it for selling the Funds' shares and to stimulate further sales. 7/ Under the circumstances, we are of the opinion that such practice was largely motivated by the Management respondents' desire to increase Management's underwriting concessions on sales of the Funds' shares 8/ And its advisory fees which would increase as Associates' sales increased with the size of the Funds. 9/ We find that the course of conduct engaged in here, which involved the use of a broker-dealer to execute transactions on behalf of the Funds in securities in which such broker-dealer did not make a market, constituted a fraud upon the Funds and their shareholders. 10/

The execution of portfolio transactions of investment companies through some broker-dealers who sell their shares has become a well-established practice in the investment company industry. Implicit in any consideration of the propriety of a reciprocal practice of this nature, however, is the overriding requirements that the investment company and its shareholders benefit and certainly that they not be injured. Where transactions are effected in a manner calculated to promote the sale of investment company shares, as in the case before us, at the cost of sacrificing the best executions on portfolio transactions, the ultimate effect of such trades is to increase the cost of securities purchased by investment companies and reduce the amount the investment companies receive for portfolio securities sold as compared with the costs of purchase and proceeds of sale they might reasonably have expected to realize had a bona fide effort been made to execute transactions at the lowest cost. The growth in size of the investment company so induced operates primarily to increase the profits of the principal underwriter and investment adviser, and at the same time, dilutes the interest of the fund shareholder in terms of asset value per share. While we recognize there may be certain economies of size, it should be emphasized that such growth cannot be promoted at the expense of shareholders. 11/

Management, Nelson, Schellenger, and Bowman also caused Delaware to sell 202,000 shares of stock of Libby, McNeill & Libby ("Libby") at \$13.50 per share on March 5, 1965, through a broker-dealer firm, although Delaware had theretofore been offered \$14 per share by another broker-dealer firm and could have obtained that price for such shares on the same day. The executing broker was selected because it had provided Management with research and statistical services and recommendations with respect to the purchase and sale of portfolio securities for the two Funds, while the other firm neither supplied such services nor dealt in the Funds' shares. 12/ The sale of the Libby stock at the lower price, through that particular firm, was designed to and did benefit Management at the expense of Delaware and its shareholders, by compensating that firm for research services even though Management was contractually obligated to provide such services and received advisory fees for them. Such conduct was incompatible with the duty of the Funds' managers to obtain the best prices for Delaware and constituted a fraud upon that Fund and its shareholders.

The execution of portfolio transactions through broker-dealers who provide research or statistical services to investment advisers of investment companies is also common practice. Where the investment company, however, receives something less than the best prices and executions solely because the executing broker provides research services to the investment adviser, the assets of the investment company are in effect used to enrich the investment adviser at the expense of the fund shareholders.

The interpositioning of Associates and the sale of the Libby stock at an unfavorable price also rendered materially false and misleading the statements in the Funds' prospectuses, used by the Management respondents in the offer and sale of the Funds' shares, that the Funds would seek the most favorable prices and executions of orders in portfolio securities. It is apparent that the Management respondents in handling portfolio transactions for the funds complied with neither the spirit nor the letter of the Funds' stated policy as to brokerage. 13/ in fact, those respondents not only failed to seek the most favorable price for the Libby stock but actually rejected a better price.

On the basis of the foregoing, we conclude that Management, Nelson, Schellenger, Bowman and Ganz willfully violated the anti-fraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 17 CFR 240.10b-5 thereunder, and that those individuals caused Management willfully to violate Sections 206(1) and (2) of the Advisers Act. 14/

The Associates respondents, in executing portfolio transactions for Delaware and Decatur on a regular basis over a period of about five years, admittedly should have known in substantially all such transactions that the Funds were in a position to obtain as favorable a price as Associates without incurring unnecessary brokerage costs and charges. Thus, the interpositioning of Associates was inconsistent not only with Management's obligation to obtain the best execution for the Funds, but with Associate's duty not to participate in an arrangement designed to defeat such

an obligation. 15/ It was also inconsistent with Associates' own obligations both to the Funds as its customers and to the customers whom Associates solicited to purchase the Funds' shares. In addition, the associates respondents sold the Funds' shares through the use of prospectuses which, since associates was the interposed dealer, they know or at least should have known were materially false and misleading.

We conclude, based on their admissions and consents, that the Associates respondents willfully violated the anti-fraud provisions of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 17 CFR 240.10b-5 thereunder.

As we have seen, various prospectuses filed by Delaware and Decatur contained materially false and misleading statements with respect to their seeking the most favorably prices and executions of orders for transactions in portfolio securities. The Funds' respective prospectuses were also materially misleading in failing to disclose that Associates was interposed between the Funds and the best available market, and the Delaware prospectuses filed after the Libby transaction were further materially misleading in failing to disclose that the Libby shares were sold at a price lower than could have been obtained. We also find that the Funds' prospectuses were misleading in failing to disclose that Associates was interposed and the Libby transactions effected for the purpose of securing benefits for Management to the detriment of the Funds and their shareholders. 16/

The Management and Associates respondents urged in mitigation that they believed, "whether or not justified," that the placement of portfolio transactions through Associates, which had employed a trader with an asserted reputation for competency, was in accord with the Funds' stated practice of placing such transactions with dealers in the Funds' shares while seeking so far as possible the most favorable prices and executions of orders; and that the best execution was being obtained through Associates because it could obtain better prices than were available to the Funds. The Management respondents further stated that they believed that Associates was securing broker's discounts from primary market houses that were not available to the Funds, while the Associates respondents claimed they believed that Associates did in fact obtain the best prices and executions for the Funds and that its acceptance of orders from the Funds and receipt of brokerage commissions for executing such orders were in accordance with industry practice and applicable law.

Respondents, however, had no reasonable basis for believing that Associates, which was not a market maker in any listed or unlisted securities, could effect portfolio transactions for the Funds at better prices than the Funds could have obtained by dealing directly with primary market makers. 17/ This is not a case of the execution of isolated transactions by a non-market maker who as agent may be able to find an institutional or other substantial customer with whom to effect the transaction. Here, Associates' portfolio transactions for the funds extended over a period of about five years and involved various securities, and it became the practice to execute over-the-counter trades through Associates. Respondents should have known that the prices Associates obtained were at best not better than those obtainable by the Funds and that Associates caused the Funds to incur unnecessary costs and charges, to the detriment of the Funds' shareholders including its own customers to whom it sold the Funds' shares.

Moreover, the Associates respondents did not have a legitimate basis for believing that their transactions in portfolio securities on behalf of the Funds were in accordance with industry practice and applicable law. Persons engaged in the securities business cannot be unaware of the obligation to serve the best interests of customers, 18/ and that interpositioning is bound to result in increased prices or costs. The Special Study of Securities Markets 19/ was critical of the justification claimed for interpositioning to obtain reciprocal business. It cited a decision of the National Association of Securities Dealers, Inc., in 1952 which held that interpositioning, done without justification, was a violation of its Rules of Fair Practice, and stressed the fiduciary standards with respect to diligence of execution in order to obtain the best price for the customer.

20/ Indeed, as early as 1942, we held that an interposed dealer had willfully violated the anti-fraud provisions of the securities acts. 21/

In determining to accept the offers of settlement submitted by the Management and Associates respondents, we gave consideration to Management's agreement to pay a total of \$319,127 to the Funds in reimbursement of their excess costs as a result of executing portfolio transactions through Associates and of the loss sustained by Delaware in the Libby stock transaction. We also considered the fact that Management, during our staff investigation, ceased executing portfolio transactions through Associates in September 1966, six months before the proceedings were instituted, and caused the Funds at that time to adopt the policy of executing such transactions directly with or through brokers who make primary markets in the securities. In addition, we took into account Management's suspension of sales of the Funds' shares, pending disposition of the proceedings, two days after the proceedings were instituted, 22/ and the Funds' consent to stop orders suspending the effectiveness of their registration statements as amended. We further considered the fact that these proceedings were being decided upon the basis of offers of settlement containing admissions and consents, and that our staff had recommended acceptance of the offers. Under all the circumstances, we deemed it appropriate in the public interest and for the protection of investors to dispose of the proceedings in accordance with such offers.

By the Commission (Chairman COHEN and Commissioners OWENS, BUDGE and WHEAT),  
Commissioner SMITH not participating.

Orval L. DuBois  
Secretary

#### **Footnotes**

1/ See Securities Exchange Act Release No. 8071 (May 1, 1967).

2/ Id.

3/ During this period, Delaware and Decatur paid to Associated unnecessary brokerage costs and charges not exceeding \$214,210 and \$11,030, respectively.

4/ From 1961 to 1966, Associates ranked among the eight dealers who sold the largest amount of shares of Delaware and Decatur. In three of those years it ranked second in the sale of Delaware shares, and first or second in the sale of Decatur shares. During the five-year period, it sold a total of about 369,901 Delaware shares for \$5,290,879 and 149,430 Decatur shares for \$1,842,317. In dollar volume, those sales amounted to about 9% of Associates' sales of mutual fund shares during the period. The dealer concessions received by Associates from Management, which ranged from 6% to 1.125% of the offering price on sales of Delaware shares and from 6.5% to 1.15% on sales of Decatur shares, totaled about \$414,105.

5/ The estimated annual cost of such trading department to Delaware ranged from \$21,759 in 1961 to \$35,598 in 1966, and to Decatur from \$2,277 to \$3,920 in those years.

6/ The telephone wires are paid for by the various broker-dealers.

7/ The obligation to secure the best execution exists irrespective of whether or not a trading unit is maintained by the investment fund.

8/ From 1961 to 1966, Management's underwriting concessions on Associates' sales of the Funds' shares totaled about \$165,243.

9/ Under Management's investment advisory contracts with the Funds, it is paid approximately 1/2 of 1% per year of the Funds' average net assets as compensation for "management research and

statistical services." In 1966, Management as investment advisers to Delaware received \$1,466,691, and as underwriter \$894,260 before expenses after reallowing \$2,231,659 to dealers. In the fiscal year ending November 30, 1966, Management for the same services to Decatur received, respectively, \$162,473 and \$115,529 before expenses after reallowing \$369,320 to dealers. Management also received as dividend disbursing and transfer agent during those periods \$85,933 from Delaware and \$13,248 from Decatur.

10/ Cf. H. C. Keister & Company, Securities Exchange Act Release No. 7988, p.5 (November 1, 1966). Even if a fund and its adviser-underwriter do not have interlocking officers or directors, and the adviser-underwriter has not undertaken to manage the fund's portfolio transactions, the underwriter may be found to have committed a fraud in the offer and sale of the fund's shares if it knew or should have known that a broker-dealer was interposed between the fund and the best market to the detriment of the fund's shareholders.

11/ The use or allocation of portfolio brokerage as extra compensation for the sale of fund shares may be potentially harmful in other respects. As we pointed out in our recent report on the Public Policy Implications of Investment Company growth (H. Rep. No. 2337, 89<sup>th</sup> Conf., 2d Sess., pp. 16-17 (1966)), the practice of allocating brokerage for sales of fund shares may not only "lead fund manager to eschew those markets where the best prices in portfolio transactions might have been obtained and may cause them to pay unnecessary charges for the execution of such transactions.: It may also, among other things, cause Fund managers to generate brokerage commissions by excessive sales and purchases of portfolio securities, and impair the integrity of dealer recommendations upon which customers rely "by tempting dealers to base their recommendations on the amount of brokerage ... received rather than on the investment needs of their customers."

12/ The firm which handled the transaction received one-half of the \$41,410 in commissions charged to Delaware, with the balance being allocated to 18 other broker-dealers who either sold shares of the Funds or provided research services to Management. In 1964, that firm ranked ninth, and in 1965 eighth, amount the largest participating brokers in commissions paid by Delaware for executions of portfolio transactions.

13/ The prospectuses of Delaware and Decatur represented that "While there is no undertaking or agreement to do so, it is the practice of the Fund, so far as possible when seeking the most favorable prices and executions of orders, to place orders for transactions in portfolio securities resulting from investment decisions with eligible dealers who have sold Fund shares using their relative sales of such shares as a factor in the allocation and with firms who have supplied research information, quotes or other services to Delaware Fund, Decatur Income Fund, and Delaware Management Company." In our opinion, even absent such representation, the prospectuses would be materially misleading in failing to disclose that the Funds did not seek the most favorable prices and executions and sustained unnecessary costs on portfolio transactions.

14/ While the Management respondents did not specifically admit violations of Section 17(a)(1) of the Securities Act, Rule 10b-5(1) under the Exchange Act, and Section 206(1) of the Advisers Act, making unlawful a scheme to defraud, we have found willful violations of those subsections pursuant to respondents' consent to such conclusions as we might draw from their admissions.

15/ See H.C. Keister & Company, Securities Exchange Act Release No. 7988, p. 5 (November 1, 1966).

16/ Following our orders of May 1, 1967, the two Funds failed amendments to their respective registration statements as amended which corrected the deficiencies upon which our orders were based, and the stop orders have been lifted. Securities Act Release No. 4866 (May 3, 1967).

17/ Cf. H.C. Keister & Company, Securities Exchange Act Release No. 7988, p. 4 (November 1, 1966).

18/ See Thomas Brown III, Securities Exchange Act Release No. 8032, pp. 2-3 (February 8, 1967).

19/ H. Doc. No. 95, 88<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1963).

20/ Pt. 2, pp. 620-24.

21/ W. K. Archer & Company, 11 S.E.C. 635, 642 (1942), aff.d 133 F2d 795 (C.A. 8, 1943).

22/ Management, which is also sponsor of Delaware Variable investment Plans for the Accumulation of Shares of Delaware Fund, as registered unit investment trust, likewise suspended the further sale of units of such trust.