WACHTELL, LIPTON, ROSEN & KATZ

February 8, 1972

To Our Clients:

SEC Statement on Future Structure of the Securities Markets

The SEC has moved decisively to preempt the leadership role in restructuring the securities industry. While the February 4 SEC statement invoked sharp congressional reaction, yesterday's Senate Committee "report" indicates that at most there will be some differences as to degree. The NYSE appears to be not capable of initiating constructive changes. Nor does any other industry leadership seem likely to emerge. The SEC statement will undoubtedly be the seminal document. Chairman Casey has done a masterful job of compromising very difficult issues, yet preserving the public interest and not affecting adversely the brokerage community.

The SEC statement contains a number of very significant points of which the following is a summary outline. The full statement is must reading for those concerned with the future of the securities industry.

1. Central Market System. The SEC proposes not a single central auction market (as did the Martin Report), but a central reporting system reflecting the principal exchange auction market, the regional exchanges markets and the third market (and perhaps the institutional block market on a separate basis). The SEC does not propose to abolish dual exchange trading or third market trading of listed securities, but rather integration of reporting in all markets and the extension of exchange-type regulations to the third market.

2. Abolition of Rule 394. The SEC proposes that there be no impediment to dealing in the best available market. NYSE Rule 394 proscribing NYSE members from trading in the third market would be abolished.

3. Broker-Dealer Access to All Markets. Through the NYSE 40% discount or other unspecified means the SEC proposes that all broker-dealers have access to all exchanges and markets.

4. Third Market Disclosure and Regulation. The third market would be subject to reporting of all trades and regulation similar to the exchange markets.

5. Compensation for Loss in Value of Exchange Seats. The loss in value of seats caused by universal access could be compensated by a transaction surcharge or tax relief. The SEC is not specific, but is cognizant of the issue.

6. Composite Transactional Tape. A study committee is to recommend the technology to achieve a tape or screen reporting system for the central market.

7. Regulation of Market Makers. Specialists, block positioners and market-makers will compete under regulations designed to achieve substantially the same purposes as present regulation of specialists -- trading should be stabilizing, markets should be orderly, market makers should be financially sound and able to maintain markets. In addition, the SEC believes that all market makers should have access to the specialist's book of limit orders, even if this means that the book is public information. A study committee is to make recommendations in this area.

8. Blocks and Block Trading. The SEC reflects concern but no specific proposals. The overall objective is to maintain liquidity. The SEC is considering at least three alternative approaches -- (1) limiting block trading where market impact is severe, (2) permitting greater price differentials for blocks but letting the public participate in favorable price differentials or (3) having a related but separate market and reporting system for blocks. A study committee is to make recommendations.

9. Portfolio Haircuts for Blocks. The SEC has raised the question as to whether institutions should be required to haircut large-block portfolio positions. This has particular significance for open-end funds. The possibility of class actions in this area is obvious.

10. Negotiated Rates. The SEC indicates a movement to eventual fully negotiated rates. The SEC wants the negotiation point to drop from $500,000 to $300,000 in April 1972 and will order the exchanges so to do. The Congressional reaction was that the break point should drop to $100,000. The conclusion that almost fully competitive rates are imminent is inescapable.

11. Paying for Research with Commissions. Rather surprisingly the SEC approves (in fact encourages) paying for research with commissions. The text of the SEC statement is:

> "It is also essential that, regardless of what level of competitively determined commission rates may be determined to be appropriate, the viability of the process by which research is produced and disseminated not be impaired. Presently, many institutions compensate brokers for research by allocation of commission business. If fixed minimum commissions were no longer to be applicable to institutional size transactions, an 'unbundling' process might result so that some brokers would charge separate fees for services such as execution, research and the like. Nevertheless, brokers who do in-depth research might prefer to charge higher commissions than other brokers whose research activity is narrower in scope or of lesser quality or value. Concern has been voiced that under such circumstances institutional managers charged with a fiduciary duty would be reluctant to pay a higher commission rate which reflected research. The Commission believes that they should not be. In our opinion, the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate, whether in the form of higher commissions or outright cash payments. It should be disclosed to investors that their money manager is willing to exercise discretion in seeking the best information and research available and does not consider that there is an obligation to get the cheapest execution regardless of qualitative consideration. It should of course be expected that managers paying brokers for research with their beneficiaries' commissions or other funds would stand ready to demonstrate that such expenditures were bona fide." (Emphasis supplied)

12. Suitability. The SEC believes "that a broker is obliged to communicate any material changes in his prior investment advice arising from subsequent research he may do to all customers whom he knows have purchased and may be holding shares on the basis of his earlier advice, at least under circumstances where to do so would not impose an unreasonable hardship on the broker." The SEC interprets the present suitability rules to require research as to basic information about securities recommended for a particular customer and even where the customer independently makes the investment decision, to call to his attention information known to the broker about the security which might reasonably be expected to affect the customer's decision.

13. Abolition of Brokerage Reciprocals for Mutual Fund Sales. The SEC is requesting the NASD to direct the abolition of reciprocal portfolio brokerage for the sale of shares of mutual funds. Absent NASD action the SEC will act. In light of the strong statement, fund managers and brokers would be well advised to cease reciprocal dealing immediately.

14. Institutional Membership. The SEC favors institutional membership where the broker affiliate does a public business and is not merely a recapture device. The SEC proposes to act promptly to have the regional exchanges terminate institutional membership for recapture purposes. The Senate Committee seems to concur.

15. Institutional Members Must do a "Large" Portion of Their Business with the Public. Somewhere between more than 50% and 80-90%; "significantly more than half". The same would apply to existing members who now manage funds or other institutional accounts. With the business and political pressures in this area the Midwest Stock Exchange 50% rule looks like the ultimate compromise. The SEC warns against reciprocal arrangements between institutions to avoid the limitations on self-dealing by institutional members.

16. Institutional Control of Real Broker-Dealers. "With respect to the second situation -- where an institution establishes or acquires a broker-dealer doing business for the general public -- we perceive no reason either of law or policy why this should not be permitted. The establishment of such a subsidiary doing a brokerage business for the public provides

a useful source of permanent capital for the securities industry. This necessarily implies elimination of the so-called 'parent test'." It is hard to see how the NYSE can continue to defend the Jefferies case in light of this position of the SEC.

17. Conflicts; Separation of Brokerage and Management. The SEC recognizes that separation was primarily a trade-off to justify denial of institutional membership. As long as institutional membership is permitted, the SEC views this conflict as no different than the other conflicts inherent in the securities industry. The SEC seems to favor the traditional approach of disclosure and regulation. The SEC notes specifically that Congress did not act in this area in the 1970 Amendments to the Investment Company Act and the SEC concludes that if at all the problem is one for Congress not SEC rule making. The SEC states:

> "We therefore believe that the conflict of interest problem which is inherent in the combination of money management and brokerage is a matter to be resolved by Congress. Only that body should decide whether or not this potential conflict can continue to be dealt with in the same manner as the other conflicts

mentioned above, by a combination of disclosure and enforcement of fiduciary obligations, or whether it is sufficiently troublesome to require separation of the two functions."

The SEC summarizes its position:

"In view of these principles, we believe that all exchange members should be required to engage in a bona fide public brokerage business, except insofar as they perform a recognized market function such as that of a specialist. Precise definition of what constitutes a bona fide public brokerage business is a matter on which we will seek the advice of the self-regulatory bodies and other interested persons. We believe that concept and its definition also warrant the attention of Congress. However, it is our view that any brokerage firm which is not doing a predominant portion of its brokerage commission business for non-affiliated persons should not be considered to be conducting a public brokerage business. Predominant means to us significantly more than half. Non-affiliated persons include individual discretionary and non-discretionary accounts and the accounts of non-affiliated institutions, but do not include institutional parents or investment companies or other institutional funds which are managed under contracts or arrangements which give the brokerage firm investment discretion. The Commission will formally request the stock exchanges to adopt uniform rules restricting membership to firms which do such a public brokerage business. If any stock exchange does not adopt such rules, we will then determine whether we should require this action or whether we should request appropriate legislation from Congress."

18. Foreign Membership in Exchanges. "In view of the increasing internationalization of securities transactions, it is relevant to a discussion of exchange membership to consider whether brokers conducting a public business but controlled or owned by foreign entities should be permitted to become members of our exchanges. We believe that this question should be resolved in the context of reciprocal access to foreign securities exchanges, with the goal of open access under equivalent competitive conditions for all qualified brokers of all nations."

M. Lipton