

April 27, 1972

To Our Clients

Institutional Membership Proposals

On April 20 the SEC presented a Whitepaper to the Williams Committee setting forth the SEC position on institutional membership and related issues. On the same day the Board of Governors of the NYSE approved for circulation and comment its own proposals. Concurrently, the Moss and Williams Committees have been hearing witnesses.

The SEC and NYSE now appear to be in substantial agreement as to their basic approach to institutional membership. The NYSE proposals are:

(1) The parent test will be eliminated. Eligibility for membership will be determined solely on the basis of the activities of the applicant without regard to the activities of its parent.

(2) The primary purpose test will be retained. It will apply only to the applicant and its affiliates and subsidiaries; not to the parent of the applicant. The applicant must derive at least 50% of its gross income from securities broker-dealer activities. There is no change in the definition of broker-dealer activities. They will continue to include floor trader, specialist, arbitrageur, market maker and general public brokerage activities. Investment advisory fees will continue to be excluded from broker-dealer activities for the purpose of the 50% gross income test. Thus most investment company advisers will continue to be ineligible for membership (and also ineligible for the 40% nonmember discount for which the primary purpose test is the same).

(3) The primary purpose test will be supplemented by two new 80% tests:

(a) 80% of the total value of securities purchases and sales by a member, on an agency or principal basis, in any six-month period, must be for accounts other than "affiliated" accounts and

(b) 80% of the total value of securities purchases and sales by "affiliates" of a member, in any six-month period, must be done through brokers other than the affiliated member.

This is the "predominant portion" test first advanced in the SEC February Market Structure Report with the further limitation of being able to do only 20% of the brokerage for an affiliate. As set forth in the SEC Whitepaper, the purpose is to prevent membership for the sole or primary objective of recapturing commissions. The SEC recognizes the Midwest Stock Exchange 50% public business rule but states a preference for 80%. There is an indication that there is room for some compromise, but closer to 80% than 50%. The SEC proposes a five-year period for noncomplying members to achieve compliance. The NYSE has proposed two years with a 60/40 requirement at the end of the first year.

In computing the total value of securities purchases and sales for the purpose of the 80% test, exempted securities such as government and municipal bonds, commercial paper and underwriting sales are excluded. The exclusion of underwriting sales makes it more difficult for mutual fund advisers to qualify.

(4) Affiliates are defined as:

(a) persons with a 5% or greater interest in the member,

(b) the member trading for its own account, except that a variety of professional-type transactions such as market making, floor trading, specialist, stabilizing and arbitraging are excluded and

(c) controlling or controlled institutions or institutional accounts (with institutions defined to mean banks, employee benefit funds, foundations, investment companies and insurance companies and with control defined in the federal securities law manner as by voting power, contract or otherwise, except that control is not presumed from the mere fact of the member having discretionary trading authority).

Private discretionary accounts and most pension fund accounts would not be affiliates. Member-firm-created investment companies would be affiliates. While it is not clear, it would appear that investment companies managed but not controlled by member firms would not be affiliates. The SEC Whitepaper is consistent with the NYSE definitions except that the SEC would include all managed investment companies whether or not control is present. It is difficult to rationalize the SEC distinction between pension funds and investment companies and the NYSE proposal is more logical and preferable.

The SEC Whitepaper goes beyond the NYSE proposals by suggesting that member floor trading is not desirable and that member trading off the floor be restricted in a manner similar to the present restrictions on floor trading, with at least 75% of all transactions required to be stabilizing and precedence given to public orders. This position follows from the basic SEC position, advanced to support exclusion of institutions unless they do a predominant public business, that direct institutional trading would give institutions an unfair trading advantage over the public. The day of the floor trader seems past. There can be little doubt that the SEC will adopt regulations for member trading off the floor in accordance with its suggestions.

It is difficult to see the purpose of the NYSE requiring that a 5% partner or stockholder in a member do 80% of his personal securities transactions with other firms. An exception for routine personal transactions under a specified dollar amount is warranted from a pragmatic standpoint both here and for a member firm investment account.

(5) Backscratching will be proscribed. One member will not be able to do its affiliates' transactions through a second member in consideration of the second member doing its affiliates' transactions through the first member.

(6) Rule 440A will be changed to prohibit adjustment of advisory fees in accordance with commission business received from the advisee. Conceptually this is contrary to the policy underlying the 1970 amendments to the Investment Company Act requiring the directors of an investment company in passing on the reasonableness of the adviser's compensation to take into account commissions earned in acting as broker for the investment company. The SEC Whitepaper does not expressly take a position on this point, but it may be significant that in discussing the question the SEC recognized the present practice of adjusting advisory fees for brokerage and did not criticize it. The SEC Whitepaper is consistent with the February Market Structure Report in indicating SEC approval of investment advisers compensating brokers for research with commissions on the theory that research benefits primarily the advisees, but disapproval of using commissions to compensate for mutual fund sales on the theory that the benefit inures primarily to the adviser.

The SEC Whitepaper contains a succinct summary of the SEC rationale for its position on institutional membership:

The fundamental premise which guides the Commission is that securities exchanges are public institutions and that members of those exchanges should be primarily serving the public. Member firms which exist solely to trade on behalf of an institutional affiliate without having obligations and responsibilities to the public are simply unacceptable to the Commission. Preserving the public nature of exchange markets and prohibiting those persons or institutions which desire simply to trade for his or their own account, contributes substantially to the inherent fairness of those markets. As long as public investors are confident that their orders will be protected and treated fairly, the Commission believes the public will continue and perhaps increase its participation in the nation's exchange markets. When and if the public investor loses confidence in the trading exchanges he will be less likely to allocate portions of his investment dollar to exchange listed equity securities. Without public participation our exchange markets would be far less orderly and liquid than today.

The SEC Whitepaper confirms the timetable on the reduction of the negotiated commission breakpoint from the \$300,000 level effective April 24, 1972 to \$200,000 in April 1973 and \$100,000 in April 1974. The Congressional hearings indicate that reduction of the breakpoint to \$100,000 and elimination of the parent test will probably satisfy most institutions and the Antitrust Division of the Department of Justice. Without pressure from these sources contrary legislation seems doubtful. There seems to be an emerging realization in the securities industry that complete abandonment of fixed commissions would not be so bad and would alleviate much of the regulatory and legislative pressure on the membership and other issues. While the PBWSE continues to be adamant on permitting institutional membership, it seems unlikely that

it will be able to reverse the developing trend. Indeed, it seems more likely that the SEC will obtain the enabling legislation requested in the Whitepaper to allow it to force the PBWSE to follow the NYSE approach without the necessity of long delay by SEC action under Section 19(b) of the Securities Exchange Act of 1934.

The masterful compromise adumbrated in the February Market Structure Report is being achieved by Chairman Casey and the SEC. If nothing more, the industry is in need of the certainty and direction of the new rules and while the long-run effects on member firms may be questionable insofar as they are essentially being barred from the growing and intellectually stimulating money management aspects of the business, the short-run benefits are substantial.

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