WACHTELL, LIPTON, ROSEN & KATZ

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To Our Clients

Market Structure

The reports of the SEC Advisory Committee on Block Transactions and the House (Moss) Subcommittee sharpen the emerging picture of future market structure. Senator Williams is scheduled to state the Senate Subcommittee position on September 7. As indicated below, it is reported to be close to that of the House Subcommittee. It is also understood that the SEC is in agreement with the principal suggestions as to the central market system and institutional membership. One can hazard the guess that it will all draw to a close in the "Securities Act of 1973".

Committee on Block Transactions. The Report assumes a central market system with competing marketmakers within a single market -- not competing separate markets. There would be a centralized quotation system, coordination of public (small) and institutional (large) orders reaching the marketmakers and reporting of all transactions on a composite tape. The specialist system would be retained, but expanded and strengthened to handle institutional orders. There would be no restrictions on institutions buying or selling blocks. The Report rejects limiting size of institutional transactions or price changes. A free market in which institutions are free to buy and sell in a manner and at a time of their own choosing is a basic tenet of the Report.

To accomplish the integration of block transactions in such a future market, the Report makes several specific recommendations:

1. The thematic recommendation is that while the basic specialist system should be preserved, there should be multiple marketmakers in the central market. Qualified block positioners should be able to quote block bids in the central market quotation system. Specialists should be permitted to act as block positioners for securities other than their specialist securities. The Report rejects the concept of a separate institutional market on the ground that it is not practicable to have two markets -- one for small orders; one for large orders.

2. The small public investor should participate in the special pricing of block transactions by requiring that the marketmaker probe the floor and give precedence to previous public orders -- apparently in a manner similar to the present NYSE procedure, recently codified in Rule 127. The Report rejects suggestions such as prior announcement and suspension of trading before block trades and requirements that all marketmakers be probed.

3. NYSE Rules 113 and 394 should be repealed so that specialists are permitted to deal directly with institutions and brokers can execute their trades where they can get the best price. Rule 394 would fall with the central market-multiple-marketmaker concept in any event.

4. Reconsideration of the application of Rules 10b-2 and 10b-6 to block transactions is recommended on the basis that the former, which is applicable only to exchange listed securities and proscribes commission compensation to salesmen in block distributions, may divert block transactions from the central market and that the latter, promulgated before the development of a market dominated by institutions with their block trades, was not designed to regulate block positioning. The Report recommends that NYSE Rules 97 and 127 prescribing the permissible market activities of block positioners and the requirements for public order participation in block trades be integrated with revision of Rules 10b-2 and 10b-6 to accommodate block trading as it has evolved.

<u>Moss Subcommittee.</u> In addition to market structure, the Study makes recommendations in the areas of entry standards, net capital requirements, customer protection, broker-dealer accounting, clearance and settlement, criminal enforcement and SEC budget and manpower. The market structure recommendations are:

(1) Approval of the SEC central-market-composite-tape concept.

(2) Repeal of NYSE Rule 394. The Study states that Rule 394 "is not necessary to make the Exchange Act work" and should be repealed immediately.

(3) When the central market system is operative, NYSE Rule 113 should be repealed.

(4) All qualified broker-dealers should be able to become registered marketmakers in any security traded in the central market system.

(5) "Members of the system would have a fiduciary duty to seek 'best execution' of trades wherever within the system such trades may be effected."

(6) Specialists and marketmakers would not be required to make continuous markets.

(7) Membership in the exchanges would become membership in the system carrying the right to execute trades.

(8) Exchange seats would be treated as contributions to the central market system by the existing holders who would be paid their value through assessments on other members of the system.

(9) Fully negotiated rates -- no fixed minimum at any level. The present SEC timetable for reduction should be speeded up.

(10) The SEC should have more oversight of the self-regulatory agencies. There should be public notice of and participation in self-regulatory agency rule-making proceedings. The NYSE reorganization has not gone far enough in the direction of the Martin Report.

(11) Congress should consider the question of mandatory treble damages, but otherwise the study finds the present court decisions as to the application of the antitrust laws to the self-regulatory agencies to be appropriate. "As we read the cases, they provide that rules, policies, practices, and actions of national securities exchanges are immune from the antitrust laws to the extent necessary to make the securities laws work, and then only to the minimum extent. Moreover, the courts have held, correctly in our view, that the supervisory presence of the SEC cannot divest the courts of their power to enforce the antitrust laws. In this connection, the courts have retained jurisdiction

to decide antitrust matters involving exchange rules instead of referring these matters to the Commission for its initial determination. This is the procedure urged upon the courts by the Department of Justice and, we believe, the correct procedure to follow. The courts do have the benefit of the Commission's views in deciding these matters, however, since the Commission can, and usually does, file friend of the court briefs in any and all such actions."

(12) No restrictions on membership but no member to act as broker for affiliated accounts. "The Subcommittee finds that any registered broker-dealer who meets prescribed capital and competency standards should be permitted to join any registered national securities exchange. Capital and competency should be the exclusive criteria for determining eligibility for exchange membership. The Subcommittee finds further that no registered broker-dealer should be allowed to perform any brokerage transactions for its affiliated accounts. Thus, we find that institutionally affiliated broker-dealers may become members of any registered national securities exchange, but that they should be precluded from handling any brokerage transactions for their affiliated institutions. We have concluded, however, that this prohibition should not take effect until the breakpoint for competitively determined commission rates has reached the $100,000 level."

The SEC 80/20 proposal is rejected on the grounds that it will have adverse impact on regional firms, cause undesirable mergers, might cause churning and create bookkeeping problems. The NYSE exception for pension funds is rejected and apparently all but private individual discretionary accounts would be treated as affiliated.

The Senate (Williams) Subcommittee is understood to have reached the same conclusions as the House Subcommittee as to negotiated rates, institutional membership and a complete proscription of brokerage for affiliated accounts other than private individual accounts. If the SEC concurs, the issue apparently will be foreclosed -- the PBW to the contrary notwithstanding. Since the ban on brokerage for affiliated accounts appears to be based on a conflict of interest rationale, it might be hoped that the ban would not apply if the broker-manager makes no charge for brokerage transactions, but is compensated solely by investment advisory fees. In the era of fully negotiated commissions and universal access there is no real reason to preclude such "no charge" brokerage. This would permit the member firms that now manage affiliated accounts to continue to do so and subject to Sections 15(c) and 36(b) of the 1940 Act, as amended in 1970 (almost it would seem for this very purpose), to continue profitably so to do by increasing the investment advisory fee by a fraction of the former brokerage. With the demise of soft dollars (although the Senate Subcommittee is understood to concur in the SEC position approving using brokerage for research), an increase in investment advisory fees is to be expected. The net result will be full visability of investment management costs and removal of any incentive to increase turnover. If the "no charge" provision is not adopted, the NYSE will be in the position of having originally barred institutions in order to preserve fixed commissions -- lost fixed commissions completely despite full institutional membership -- put its members at a substantial disadvantage in the fast growing and profitable money management business. An almost classic example of the bull, bear and pig story.

Recent Developments

Brokers Financial Reports. Effective September 30, 1972, Rule 17a-5 has been amended to (a) require brokers to file with the SEC and furnish annually to their customers an audited balance sheet, a statement of net capital and a notice of availability for customer inspection of any comments by the auditing accountants as to material inadequacies in internal controls and (b) file and furnish quarterly an unaudited balance sheet and a statement of net capital.

Effective July 31, 1972, Rule 17a-5 has been amended to require a broker to file a notice with the SEC in the event of termination of the engagement of the accountant engaged to conduct the broker's audit.

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