

January 25, 1973

To Our Clients:

Institutional Membership

The SEC has adopted Rule 19b-2, effective March 15, 1973, and the NYSE has proposed amendments to its Constitution (Art. IX, Sec. 7) and Rules (2 and 318) to implement Rule 19b-2. As a result, institutional membership will be permitted subject to the 80/20 test.

Parent Test Eliminated

The "parent test" of Rule 318 is eliminated. Eligibility of a broker for NYSE membership is now determined solely by the broker's own business, without reference to the business of its parent. A broker subsidiary of an insurance company or investment management company is eligible for NYSE membership if its primary purpose is the transaction of business as a broker or dealer in securities. To meet the primary purpose test, the broker subsidiary must derive 50% of its gross income from floor activities or public business as a broker or dealer. The typical mutual fund distributor subsidiary would meet this test. Any institution so desiring is able to establish a broker subsidiary which could qualify under this test. Only domestic and Canadian firms can be members of the NYSE. No member can have a parent other than a domestic or Canadian parent -- therefore broker subsidiaries of foreign banks, brokers and institutions remain ineligible for NYSE membership.

80/20 Test

In addition to the "primary purpose test", members of the NYSE are now subject to the 80/20 test. Not less than 80% of the total value of all securities transactions effected on all domestic exchanges by or through the member must be for the accounts of other than affiliated persons. 20% can be for affiliated persons such as an insurance company parent or a mutual fund advised by the member. The 80/20 test is applied to all transactions during the previous six months.

Affiliated Person

Affiliated person is defined as:

(1) A 25% shareholder or 25% partner (share of profits or voting power).

(2) A principal officer - president, executive vice president (but not a plain vice president), treasurer, secretary or a person performing similar functions (thus including as an affiliated person a chairman, vice chairman, managing director, etc. who performs principal executive functions of the type performed by a president or executive vice president).

(3) A 5% shareholder or 5% partner who is active in the business of the member.

(4) A person in whose account a principal officer, 5% shareholder or 5% partner has a direct or material indirect beneficial interest.

(5) A mutual fund or investment company of which the member is the investment adviser.

(6) A person directly or indirectly controlled, controlling or under common control with the member.

(7) The member trading for its own account except defined market making transactions as a specialist, odd-lot dealer, block positioner, registered floor trader or arbitrageur. Also excepted are stabilizing trades during distributions, approved transactions to maintain an orderly market and transactions to offset errors.

Discretionary Accounts

A typical discretionary account, individual or institutional, is not an affiliated person. Rule 318 provides that "the right to exercise investment discretion with respect to an account, without more, shall not constitute control." The SEC release promulgating Rule 19b-2 states that the Rule is intended to permit insurance companies with respect to separate account pension funds and banks and investment counsel with respect to discretionary investment management accounts

January 25, 1973

of all types to establish broker subsidiaries as NYSE members, thereby putting them on an equivalent basis with present NYSE members who manage discretionary accounts. The competitive factor with respect to mutual funds is handled in the opposite manner; fund transactions are affiliated business and present members who advise funds have to comply (subject to a three-year phase-in period) with the 80/20 test in the same manner as broker subsidiaries established by non-member fund advisers.

No Reciprocal Arrangements

Backscratching is specifically prohibited. Rule 318 defines as an affiliated person an affiliated person of another member to the extent that any transactions with such affiliated person is pursuant to a reciprocity arrangement.

Application of the 80/20 Test

The 80/20 test is based on the dollar value of exchange transactions - not the commissions. A member must be in compliance based on the previous six consecutive months prior to whatever date is selected - a rolling period type of test. The test is applied to all transactions by the member on domestic exchanges. Transactions on foreign exchanges and OTC and underwriting transactions do not enter into the test. The 80/20 test applies to the member's transactions - not the affiliate's. Provided the member meets the 80/20 test, 100% of the affiliate's transactions may be effected through the member. Members who do not meet the 80/20 test do not have to dispose of their affiliates - merely refrain from effecting exchange transactions for the affiliates in amounts that would exceed 20% of the members' total exchange transactions.

Transactions for discretionary accounts are public business for the purpose of the 80/20 test, therefore they increase the base for transactions for affiliates. This is specially significant for mutual fund advisers who also manage or advise pension and individual discretionary accounts. In this connection, it should be noted that the NYSE has not proposed to amend Art. XV, Sec. 2(h) of its Constitution so as to

remove the parent test in determining the eligibility of a non-member broker for the 40% non-member access discount. Unless this provision is amended, it appears that institutional affiliates will have to buy seats in order to enjoy reduced commissions. (The SEC has indicated that it expects the exchanges to eliminate the parent test for nonmember access, Release 9950, p. 183).

Market Making Transactions

The market making transactions that are defined as public business are:

(1) Specialist transactions in securities in which the specialist is registered - this includes both agency and principal transactions. As the SEC release recognizes, the large dollar volume of specialist transactions will support a large amount of affiliate transactions and thus make specialists attractive acquisitions for institutions desiring membership. The SEC release notes that the attraction of additional capital to market making is desirable.

(2) Odd-lot transactions by odd-lot dealers in securities in which the dealer is registered.

(3) Positioning block trades, except where an affiliate is a party to the trade. Block positioner is defined in the context of the transaction, rather than the regular business of the member, so that all members qualify.

(4) Transactions by registered floor traders - either on or off the floor - in accordance with the floor trading rules. Off-floor trading by members - the typical firm trading account - are affiliate transactions. Members whose business is primarily off-floor trading for their own account are affected severely by the Rule.

(5) Stabilizing transactions complying with Rule 10b-7.

(6) Arbitrage transactions - both offsetting or hedging between markets or a convertible and the underlying security and risk arbitrage in acquisitions, tenders and similar transactions.

(7) Transactions with the approval of a floor official for maintaining an orderly market and the reversal of such transactions.

(8) Error account transactions.

Three-Year Phase-In

Present members are afforded a three-year phase-in period. If within 30 days after the new rules become effective, a member files with the NYSE a detailed plan for achieving compliance and updates such plan annually thereafter, the member will have three years to achieve compliance. No percentage test is applicable during the three-year period. The compliance plan must be bona fide and the NYSE must be satisfied that it is reasonably designed to achieve compliance.

Procedure and Antitrust

The SEC release covers specifically the procedural and antitrust issues that have been raised in connection with Rule 19b-2. The SEC has created a record that appears to leave very little, if any, room for successful attack on either basis.

Future Action

Congressman Moss and Senator Williams have criticized Rule 19b-2. Both have stated continued support for the 100/0 test their subcommittees have proposed. They would permit institutional membership but proscribe any transactions for affiliates. While it is doubtful that there is now any substantial support for the 100/0 test, attention has been focused on the issue and with increased institutional membership there is little doubt that one of the burning issues of the future will be the separation of brokerage and money management. An issue that will probably revive the old issue of separation of brokerage from the dealer and underwriting functions. One continues to feel that the NYSE has made a poor trade. Its and its members long-run interests are not the preservation of fixed commissions, but flexibility and the ability to engage in all aspects of the securities business and the creation of a true exclusive central market.

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