WACHTELL, LIPTON, ROSEN & KATZ

June 14, 1973

To Our Clients:

Institutional Membership - Proposed
Amendments to NYSE Rules 318 and 440A

In order to narrow the availability of institutional membership and nonmember access discounts for broker affiliates of institutions -- yet answer the argument that members who manage investments on a fee basis have a competitive advantage over nonmember investment managers through the members' ability to offset brokerage commissions against management fees -- the NYSE is proposing to amend Rules 318 and 440A to include as "affiliated" business transactions for discretionary pension and other institutional accounts and to prohibit commission credits against investment advisory fees.

The amendment to Rule 318 would delete the present provision that investment discretion alone does not make a discretionary or managed account "affiliated" for the purpose of the 80/20 test. Instead, all controlled or discretionary institutional accounts would be included in the affiliated category. Under the new provision, it does not matter whether or not there is a management contract nor are the terms of the management arrangement relevant. The only questions are is it an institutional account and does the member have investment discretion. If so, it is "affiliated".

Managed or discretionary _individual_ accounts will continue to be treated as public business for the purpose of the 80/20 test. Included within the definition of institutional accounts are banks, all manner and type of pension and employee benefit plans, foundations and other nonprofit organizations, investment companies and insurance companies and funds. While the drafting of the proposed amendment is not clear, "insurance funds" apparently is intended to cover separate accounts as well as insurance companies themselves. Other drafting problems - such as an ambiguity as to whether an institutional account would be "affiliated" if an officer of the institution had final investment decision and exercised it with respect to each transaction - are present in the proposed amendment. The language of Sen. 470 (the revised Securities Act of 1973), which would adopt a 100/0 test, is much more precise in defining "affiliated" institutional accounts and foreclosing loopholes.

73-0018

Under Rule 385, the nonmember access discount is not available for transactions by "affiliated" accounts. Since Rule 385 incorporates the "affiliated" account definition of Rule 318, the proposed amendment would prevent banks and insurance companies from using the nonmember access discount to recapture commissions on transactions by managed pension and other institutional accounts and separate accounts.

The amendment to Rule 440A would prohibit the adjustment of investment advisory and similar fees on the basis of the amount of commissions received by the member. Existing arrangements of this type would have to be terminated no later than three months after the effective date of the amendment. The purpose of the amendment is to remove the competitive advantage of members in being able to offset advisory fees with commissions and eliminate this loophole (theoretical, if not real) in the no rebate rule.

The amendment would not require members to establish minimum advisory fees; therefore, contemplated commissions may be taken into account in the original negotiation of the advisory fee. Thus, investment companies managed by member firms can continue to meet the requirement of § 15(c) of the 1940 Act that the independent directors consider the reasonableness of the management fee in light of all consideration, including brokerage commissions, paid by the investment company to the adviser.

The proposed amendment is not clear as to whether adjustment is proscribed for all commissions or only NYSE listed commissions. The circular proposing the amendment says that it is intended to apply to NYSE listed commissions. In view of the SEC position on investment company recapture of tender-offer-soliciting-dealer commissions, it would seem that an exception for such commissions must be made. There is no indication that the NYSE has considered the loophole and diversion to regional exchanges potentials, if Rule 440A does not prohibit adjustment for OTC and regional exchange transactions.

M. Lipton