WACHTELL, LIPTON, ROSEN & KATZ

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To Our Clients:

Trading by Member Firms

Section 11(a) of the 1934 Act, as added by the Securities Acts Amendments of 1975, proscribed member trading for managed accounts other than accounts of natural persons and thereby settled the institutional membership issue by opening membership but prohibiting institutional members from acting as their own member-broker. Ambiguities in Section 11(a) as enacted led the SEC to assert that floor trading was abolished and that a member could not "effect" a managed account transaction through another member. Section 11(a) also gave the SEC sweeping rulemaking authority to create exemptions -- including exemptions that reverse the Section's proscriptions.

On the basis that Section 11(a) as enacted does not reflect the effects of fully negotiated rates on the institutional membership question and is not in accord with the basic statutory mandate to promote competition in the securities industry, the SEC has proposed three rules which would (1) permit all types of member trading, (2) require members trading for managed accounts to charge a flat annual management fee and no brokerage commissions or transaction fees and (3) would permit proscribed member transactions to be effected through another member. The proposed rules overlap and in part are inconsistent, e.g., there would be no need for members to effect transactions through other members if the first two proposals were adopted. Each of the proposed rules is conditioned on the exchange adopting rules providing for complete access by any qualifies person, including institutions, banks, and foreign brokers.

Proposed Rule 11a2-1 would permit all member trading (including floor trading) on condition that the member's order yield priority to orders at the same price (regardless of size) by nonmembers. Thus an institutional member would be able to execute its own trades. The priority requirement would apply to all member transactions, including those of specialists and block positioners. Trades by an account in which a member or an associated person of a member has a 10% or greater interest would be treated as member trades.

Proposed Rule 11a1-3 would permit members to effect transactions for managed accounts if the member does not charge a brokerage commission or transaction fee and the member acts only as agent and does not itself participate for its own account. Thus, the rule would limit members who execute for managed accounts to a flat annual management fee and would prohibit principal transactions or participations. The SEC has requested special comment on the question of what principal transactions and participations should be permitted consistent with the prevention of conflicts. The rule would permit the payment of brokerage commissions to unaffiliated brokers whenever there is an appropriate reason for going to an outside broker. The SEC indicates that if the rule is adopted, money managers would not have to become brokers, provided there was full disclosure to the managed account and informed consent.

Proposed Rule 11a2-2 would permit a member to effect a transaction that it is proscribed from affecting by Section 11(a) through another member, if the proscribed member does not do the floor brokerage and the order is entered from off the floor.

M. Lipton