UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE SECRETARY

September 10, 1990

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
Room 2125, Rayburn House Office Building
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Dingell:

This is in response to your request for the Commission's views on a proposal by Fidelity Management & Research Company ("Fidelity") to amend Section 11(a) of the Securities Exchange Act of 1934 (the "Exchange Act"). This proposal would remove the provision in Section 11(a) that prohibits a broker-dealer from effecting orders on an exchange of which it is a member for managed accounts. On September 25, 1989, Richard Ketchum, Director, Division of Market Regulation, sent you an interim response briefly outlining Fidelity's proposal and presenting a summary of the background of Section 11(a) and the issues presented by Fidelity's proposal. Subsequently, the staff of the Division of Market Regulation completed a study of these issues. Attached is a Report prepared by the staff on the effect of Fidelity's proposal on money managers and their affiliated broker-dealers.

The Report presents a brief background of industry developments that led to the addition of Section 11(a) to the Exchange Act, the legislative history of Section 11(a), and a discussion of Rule 11a2-2(T) adopted under the section. The Report also discusses current industry practice and the effect the proposed amendment might have on such practices. The Report recommends that, subject to the conditions expressed in the report, the Commission should support the proposed legislative amendment to Section 11(a) of the Exchange Act.

The Commission concurs in the conclusion of the staff Report. Chairman Breeden was recused from participation in this matter.

If you have any further questions, please contact Richard G. Ketchum, Director, Division of Market Regulation, at 272-2836.

For the Commission.

Sincerely,

Jonathan G. Katz
Secretary

Enclosure

REPORT OF THE DIVISION OF MARKET REGULATION OF THE SECURITIES AND EXCHANGE COMMISSION ON A PROPOSED INDUSTRY AMENDMENT TO SECTION 11(a) OF THE SECURITIES EXCHANGE ACT OF 1934

September 10, 1990

I. INTRODUCTION

This report was prepared in response to Congressional requests for the views of the Securities and Exchange Commission ("Commission") or its staff on a legislative proposal to amend Section 11(a) of the Securities Exchange Act of 1934 ("Exchange Act").[1] This proposal was submitted to Congress by Fidelity Management & Research Company ("Fidelity"), an investment adviser registered under the Investment Advisers Act of 1940 (the "Advisers Act").

Section 11(a) provides, generally, that exchange members and their associated persons are prohibited from effecting securities transactions on the floor of an exchange of which they are members for their own accounts, accounts of their associated persons, and

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1 *See* letters from Senator Christopher Dodd, Chairman, Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs to David S. Ruder, Chairman, Securities and Exchange Commission (July 24, 1989); Representative John Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives to David S. Ruder, Chairman, Securities and Exchange Commission (July 25, 1989); and Representative Edward Markey, Chairman, Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce to David S. Ruder, Chairman, Securities and Exchange Commission (July 25, 1989).

accounts over which the member or its associated person exercises investment discretion (collectively "covered accounts"). In its submission, Fidelity analyzed the effect of Section 11(a) and its exemptions on money managers' activities. It concluded that Section 11(a) as presently applied imposes substantial indirect costs on money managers such as Fidelity. Therefore, Fidelity proposed to amend Section 11(a) by deleting the phrase "or an account with respect to which [the member] or an associated person thereof exercises investment discretion". This amendment would exclude from Section 11(a)'s prohibitions only the execution by broker-dealers of trades for accounts that they or their affiliates manage. The proposal would not change the Section's limitations on broker-dealers trading for their own accounts or accounts of their associated persons.

II. BACKGROUND

A. Section 11(a)

Section 11(a) was added to the Exchange Act by the Securities Acts Amendments of 1975 (the "1975 Amendments").[2] As noted above, Section 11(a)(1) prohibits exchange members from effecting securities transactions on national securities exchanges of which they are members for their own accounts, the accounts of their associated persons, or accounts managed by the member or its

[2] Pub. L. No. 94-29 (June 4, 1975).

associated persons. This general prohibition is qualified by eight statutory exceptions. [3] Exchange member broker-dealers effecting

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[3] Section 11(a)(1) provides that:

> It shall be unlawful for any member of a national securities exchange to effect any transaction on such exchange for its own account, the account of an associated person, or an account with respect to which it or an associated person thereof exercises investment discretion: Provided, however, That this paragraph shall not make unlawful-
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> (A) any transaction by a dealer acting in the capacity of market maker;
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> (B) any transaction for the account of an odd-lot dealer in a security in which he is so registered;
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> (C) any stabilizing transaction effected in compliance with rules under section 10(b) of this title to facilitate a distribution of a security in which the member effecting such transaction is participating;
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> (D) any bona fide arbitrage transaction, any bona fide hedge transaction involving a long or short position in an equity security and a long or short position in a security entitling the holder to acquire or sell such equity security, or any risk arbitrage transaction in connection with a merger, acquisition, tender offer, or similar transaction involving a recapitalization;
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> (E) any transaction for the account of a natural person, the estate of a natural person, or a trust (other than an investment company) created by a natural person for himself or another natural person;
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> (F) any transaction to offset a transaction made in error;
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> (G) any other transaction for a member's own account provided that (i) such member is primarily engaged in the business of

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orders for their managed accounts rely primarily on rules adopted under the last statutory exception, Subsection (H).[4] Subsection (H) authorizes the Commission, by rule, to grant additional

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underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, or any one or more of such activities, and whose gross income normally is derived principally from such business and related activities and (ii) such transaction is effected in compliance with rules of the Commission which, as a minimum, assure that the transaction is not inconsistent with the maintenance of fair and orderly markets and yields priority, parity, and precedence in execution to order for the account of persons who are not members or associated with members of the exchange; and

(H) any other transactions of a kind which the Commission, by rule, determines is consistent with the purposes of this paragraph, the protection of investors, and the maintenance of fair and orderly markets. 15 U.S.C. § 78k.

Statutory exceptions (A) through (F) were included either because the activities, such as market making, were considered beneficial to the markets, or because they were viewed as posing no threat to the functioning of the markets. Report of the Comm. on Banking, Housing and Urban Affairs of the United States Senate on S.249, 94th Cong., 1st Sess., Report No. 94-75 at 68 (April 14, 1975) ("Senate Report"). S.249 was the Senate version of what became the 1975 Amendments.

[4] Broker-dealers effecting proprietary orders on an exchange floor also frequently use the exception provided in Subsection G. Subsection (G) provides a general exception for a member's proprietary transactions if the member is engaged primarily in a public securities business (the so-called "business mix" test) and the member yields, pursuant to Commission rules, priority, parity, and precedence to public orders over the member's proprietary account orders. This provision was implemented by Exchange Act Rule 11a1-1(T). This exception is not available for orders from managed accounts.

exceptions consistent with the stated purposes of the Section, the protection of investors, and the maintenance of fair and orderly markets.[5] Under this authority, the Commission, in 1978, adopted Rule 11a2-2(T).[6]

To understand the import of the suggested amendments to Section 11(a), it is useful to review the events and concerns that led to the enactment of that Section. Section 11(a) is a remnant of a regulatory scheme designed to deal with a transitional period for the securities industry. Prior to 1975, the securities industry operated in an environment of fixed commission rates and limited access to exchange membership. The commission rates

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5 In discussing Subsection 11(a)(1)(H), the Senate Report stated that:

> It is the Committee's view that such broad Commission discretion is appropriate in light of the rapidly changing economic and regulatory patterns affecting exchange trading. In the area of prohibiting a member's trading for its own account, the Committee believes legislation should do no more than create presumptive standards addressed to the current problems flowing from the combination of brokerage and money management. The Commission should have authority in the furtherance of the purposes of the Exchange Act to fashion either more restrictive or more flexible standards for the future, as circumstances may demand. S. 249 would achieve this result.

Senate Report at 68.

6 Rule 11a2-2(T) provides a partial exemption to Section 11(a)'s blanket prohibition by allowing the affiliated broker of a money manager to effect securities transactions if, among other things, the order is executed by an unaffiliated broker on the floor of the exchange.

required to be charged to institutional investors trading in large amounts differed little from the rates charged on small trades. These fixed rates were considered to be uneconomically high by most institutional investors.

During the 1960's, trading volume surged on the exchanges, ultimately resulting in the "back office crisis" in the late 1960's.[7] One source of the increased exchange trading volume was a marked increase in trading by money managers on behalf of institutional accounts, such as pension funds, trust accounts, insurance accounts, and investment companies. Institutional trading increased both in absolute terms and as a proportion of total market volume. As a result, the execution of orders for

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7 The "back office crisis" of 1969-70 has been described as one of the most prolonged and severe crises in the securities industry. This period experienced widespread failures of broker-dealer firms and concern for the funds of their customers. These failures followed a prolonged period of favorable business conditions, with increasing brokerage income and rising securities prices. Under these conditions, expansion of broker-dealer sales efforts and overhead were not properly supported by increased firm capital or expanded back office operations. A veritable explosion in trading volume clogged an inadequate machinery for the control and delivery of securities. Failures to deliver securities and to make payment ricocheted through the industry as firms lost control of their records and of the securities in their possession or charged to them. Operational conditions deteriorated so severely that securities markets were required to cease trading one day each week and later to limit daily trading hours. The causes were basic structural weaknesses in the clearance and settlement of securities transactions and the net capital of many firms. Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendation of the Commission, HR Doc. 92-231, 92d Cong., 1st Sess. 1 (1971).

institutional investors became an increasingly important part of the business of many brokers.

As fiduciaries, institutional money managers were (and are) obligated to obtain best execution on their transactions. [8] In order to meet their fiduciary obligations and lower their effective commission costs, institutional money managers in the fixed commission era engaged in a variety of unusual trading practices. Some institutions formed brokerage subsidiaries that became members of regional exchanges. [9] Using their regional exchange member

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[8] Senate Report at 64. In the Senate Report, best execution was described as "the best price [for a security] net of all commissions and other transaction costs". Other transaction costs may include intangibles such as the speed and timing of execution. The Commission has noted that a money manager may meet its obligation to obtain "best execution" if it executes transactions for the client in a manner that assures the client's total costs or proceeds in each transaction will be the most favorable under the circumstances. To determine what execution is most favorable, the money manager must consider all the broker's services in placing an order, including, among other things, the value of research to customers, execution capability, financial responsibility, responsiveness to the money manager and commission rates. Lowest possible commission rates are not the determinative factor, but instead whether the transaction represents the best qualitative execution for the managed account. <u>See</u> Securities Exchange Act Release No. 23170 (April 23, 1986), 51 FR 16004.

[9] Prior to 1975 the exchanges responded in various ways to institutional attempts to obtain membership. Neither the New York Stock Exchange, Inc. ("NYSE") nor the American Stock Exchange, Inc. ("Amex") allowed institutions or their brokerage affiliates to become members. As a result, institutional investors that desired to execute transactions on the NYSE or Amex were forced to pay the full fixed commission rate to an unaffiliated member

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subsidiaries, institutions would route their orders for NYSE or Amex-listed stocks through the regional exchange member. [10] Such re-routing reduced the institution's effective commission cost by allowing the money manager to "recapture" a part of the fixed commission through its regional member firm. Money managers also resorted to other byzantine devices, such as reciprocal practices and give-ups [11] to broker-dealers or execution of trades in the third market, [12] to circumvent the fixed commission rate structure then in place. [13]

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[9](...continued)
firm. In contrast, the regional exchanges eagerly accepted institutional membership and its concomitant order flow.

[10] Senate Report at 61-62. See also, Securities Industry Study, Report of the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, HR Doc. No. 92-1519, 92d Cong. 2d Sess. 133 (1972).

[11] The term "give-ups" refers to a situation in which a money manager directs its broker to give a portion of the commissions paid that broker to another broker that had no role in the transaction, but supplied unrelated services to the money manager.

[12] Institutions would purchase exchange-listed securities from non-member (i.e., "third market") brokerage firms on a competitive net price basis, thus avoiding the exchange's fixed rate commission.

[13] Institutions also negotiated with brokers for research, which was in effect paid for by the fixed commission fee. With the unfixing of commiss[illegible] [illegible]tes in 1975, brokers and fiduciaries feared that fidu[illegible]ries paying negotiated commissions would no longer be able to compensate brokers for research through commissions. Congress responded to this concern by adopting Section 28(e) of the Exchange Act as part of the 1975 Amendments. Section 28(e) provides a safe harbor for fiduciaries who in good faith pay more than the lowest possible commissions in return for brokerage and research services.

Although the NYSE and Amex did not allow institutional money managers to become members, they allowed their existing members to engage in the money management business. As a result, unlike their non-member institutional counterparts, NYSE and Amex members could increase the performance of accounts under their management simply by reducing their management fees, while continuing to profit from the fixed commissions charged in executing transactions for those accounts. The accounts of institutional money managers who could not join these exchanges were subject to both a normal management fee and the cost of the fixed commissions.[14] Thus, non-member money managers potentially were at a competitive disadvantage vis-a-vis member firm money managers.

In response to these and other systemic problems in the securities industry, the Commission and the Congress engaged in extensive studies of the changes in the securities markets.[15] The

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14 Normally, money managers charge their accounts a management fee designed to cover the cost of administrating the account. Commission charges on securities transactions are not included in the management fee but are paid separately by the account out of its assets. Thus a money manager can improve the performance of an account either by lowering the management fee, which lowers the manager's profits, or by negotiating for lower commissions paid on transactions, which lowers the broker's profits.

15 See, e.g., Institutional Investor Study, Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971); Securities Industry Study, Report of the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, H.R. (continued...)

result of these studies was the enactment of the 1975 Amendments, including Section 11(a). Concurrent with the 1975 Amendments, fixed commission rates were eliminated and access to exchange membership was made available on a relatively unrestricted basis.

The legislative history of Section 11(a) reflects Congressional concern not only with market dislocations and trading advantages, but with perceived conflicts of interest arising from the combination of money management and brokerage functions. In articulating its concerns, Congress specifically noted the potential for broker-dealers to churn their managed accounts in order to increase their commissions, or for a broker-dealer to pressure the managers of its advised accounts to buy particular securities so that the broker-dealer could complete a block transaction for another customer or close an underwriting of a new issue. [16] Congress also noted that broker-dealers might prefer managed accounts over other customers in the execution of their orders.

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[15] (...continued)
Doc. No. 92-1519, 92d Cong. 2d Sess. (1972); Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 92-231, 92d Cong., 1st Sess. (1971); Securities Industry Study, Report of the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, S. Rep. No. 93-13, 93d Cong., 1st Sess. (1973); and Statement on the Future Structure of the Securities Markets (March 14, 1972), 37 FR 5286.

[16] Senate Report at 63-65.

Congressional consideration of the issues of institutional access to exchanges and the combination of money management and brokerage resulted in the adoption of the managed account provision of Section 11(a). This provision barred a broker-dealer from executing transactions on an exchange for a managed account, absent exemption. In practice, this provision required institutions to channel their exchange business through unaffiliated broker-dealers, while also forcing exchange members to execute trades for their managed accounts through an unrelated firm.

Congress' legislative initiatives to reform the securities markets began in 1973, continued through 1974, and culminated with the 1975 Amendments that included the restrictions imposed by Section 11(a). By 1975, however, some of the underlying premises of the Section had altered. In fact, a month before the 1975 Amendments were enacted, the Commission's rule abolishing fixed commission rates took effect.[17] Just prior to passage of the bill, the Commission testified regarding Section 11(a) that:

> [D]evelopments not present when we first adopted Rule 19b-2, and when S.470 was passed - such as the elimination of fixed commission rates, and creditable progress toward the development of a national market system - call into serious question the need for a legislative formulation to deal with

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[17] 17 CFR 240.19b-3, adopted in Securities Exchange Act Release No. 11203 (Jan. 23, 1975), 40 FR 7403.

this issue, and particularly a legislative formulation too rigid to permit the Commission to adjust its rules to changing conditions and circumstances. [18]

Congress' view regarding the continued necessity of a statutory prohibition on the combination of money management and brokerage differed somewhat from the Commission's. The Senate agreed that elimination of fixed rate commissions would alleviate some of the problems potentially associated with the combination of brokerage and money management. But the Senate also noted that:

> "As the industry moves into an era of competitive commission rates, a new conflict of interest will arise as money manager-brokers have to determine, without the benefit of arms' length bargaining, what constitutes a fair commission charge for transactions they execute for their managed accounts."[19]

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[18] Securities Acts Amendments of 1975, Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs on S.249, 94th Cong., 1st Sess. 256 (1975). Rule 19b-2 was adopted in 1973 during the era of fixed commission rates, in response to the market distortions caused by limited access to some exchange membership. The Rule restricted membership on all exchanges to those broker-dealers that did a public business, as opposed to a private or affiliated business. A "public" business was defined as effecting 80% of the value of the member's exchange transactions with non-affiliated persons. In 1976, about eighteen months after passage of the 1975 Amendments the Commission rescinded Rule 19b-2. S.470 was the precursor to S.249.

[19] Senate Report at 64-65.

The Senate concluded that, even though there was little evidence that the conflicts of interest had led to widespread breaches of fiduciary duty, "the existence of these conflicts [was] extremely troublesome." [20]

In adopting Section 11(a), however, Congress recognized the need for Commission rulemaking flexibility. Consequently, in Subsection (H) Congress granted the Commission broad exemptive powers. In the interim period before Section 11(a) went into effect, [21] the Commission began the process of preparing rules to implement the statute.

B. Rule 11a2-2(T)

In the year between enactment of the 1975 Amendments and the Commission's initial rulemaking proposals under Subsection (H) of Section 11(a), the securities markets underwent rapid adjustments. The impact of negotiated commission rates was particularly noticeable. A Commission study in 1976 indicated that, during the

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20 Senate Report at 65.

21 Initially, Section 11(a) of the 1975 Amendments was to take effect in 1978. At the Commission's request, however, effectiveness was subsequently postponed to 1979. Letters from Harold M. Williams to Walter F. Mondale, Thomas P. O'Neill, Jr., Harley O. Staggers, and Harrison A. Williams (Feb. 22, 1978), and Memorandum of the Securities and Exchange Commission in Support of its Recommendation that the Congress Delay the Full Effectiveness of Section 11(a) Until November 1, 1979.

period from May 1976 to September 1976, institutional customers negotiated average discounts of 36% from the old fixed commission rate on orders between 1,000 and 10,000 shares. Adjusted for inflation, the discount was closer to 40%. [22] Institutional commission rates have continued to fall and are now about 50% less than the pre-1975 fixed rate. [23]

In addition, during the time between enactment and effectiveness of Section 11(a), access to exchange membership was opened to all qualified broker-dealers. [24] Therefore, institutional

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22 Securities and Exchange Commission, Fourth Report to Congress on the Effect of the Absence of Fixed Rates of Commissions (Jan. 28, 1977).

23 Greenwich Reports, Institutional Investors 1989, A New Ball Game (1989).

24 The 1975 Amendments amended Section 6 of the Exchange Act to require that the rules of a registered national securities exchange must provide that any registered broker-dealer may become a member (subject to exchange limitations on the number of members), and that membership may be denied only for specified reasons, such as the applicant being statutorily disqualified or unable to meet its financial obligations. In general, exchange rules must not impose any burden on competition not necessary or appropriate in furtherance of the statute. Section 6 does not allow exchanges to discriminate against institutional members that meet the qualifications of registration as a broker-dealer.

Prior to 1975, Section 6 only provided that an exchange could register with the Commission by providing the Commission with, among other things, an agreement to abide by the securities laws and regulations, and copies of relevant organizational documents, rules and procedures, including exchange rules designed to discipline members for infractions of the rules and statutes, or for acting in a manner inconsistent with just and equitable principles of trade. Section 6 also (continued...)

investors and their affiliated brokers could become members if they were registered as broker-dealers and met net capital requirements and exchange qualifications. Without the impetus of fixed rate commissions, however, exchange membership was of less interest to institutions than before 1975. Instead, non-member money managers appeared to be content to negotiate reduced commissions.

After 1975, the Commission was concerned that the 1975 Amendments might have unintended and undesirable effects in light of the changes in the markets since their enactment. In particular, the Commission was concerned that Section 11(a) might introduce unnecessary inefficiencies in the order execution process. In addition, it might place exchange members, especially regional and smaller members, at a competitive disadvantage, leading to more concentration in the industry and reducing the availability of money management services to smaller regional institutional accounts that had traditionally been serviced by small regional brokerage firms.[25]

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[24](...continued) provided that an exchange could adopt any rules not inconsistent with the securities laws. The section contained no provisions on membership requirements.

[25] <u>See</u> Securities Exchange Act Release No. 16406 (Dec. 5, 1979) (Survey of Exchange Members on the Impact of Section 11(a) and Rule 11a2-2(T)). Regional and smaller exchange member firms traditionally were able to attract money management business by lowering their management fees and relying more on the income from fixed commissions. After passage of Section 11(a) and the unfixing of commission rates, such members feared that the money management business would move to larger, non- (continued...)

Accordingly, the Commission adopted a number of rules to modify the operation of various provisions of Section 11(a). In particular, Rule 11a2-2(T) was adopted in 1978 to provide a partial exemption from the managed account provision of Section 11(a), while addressing aspects of its underlying purposes. [26] Pursuant to the Rule, exchange members may effect transactions for covered accounts if, among other things, the member has the trade executed on the exchange by an unaffiliated broker. Rule 11a2-2(T) is frequently referred to as the "effect vs. execute" rule. [27]

Rule 11a2-2(T) contains requirements designed to reach the problems of competition and conflicts of interests that Congress indicated were the primary purposes behind Section 11(a). With

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[25](...continued) member money managers who could take advantage of low negotiated commission charges by charging their accounts only a management fee and paying the low commission out of that fee. Meanwhile, the small member firms, who also would have to use an unaffiliated broker to effect transactions, would have to charge their accounts both the regular management fee and the brokerage fee. Rule 11a2-2(T) was designed to redress this new imbalance by allowing the member to effect certain covered account orders and receive a portion of the execution fee.

[26] Securities Exchange Act Release No. 14563 (March 14, 1978), 43 FR 11554.

[27] Rule 11a2-2(T) itself defines "effects" broadly as the performance of "any function in connection with the processing of [a] transaction, including, but not limited to, (1) transmission of an order for execution, (2) execution of the order, (3) clearance and settlement of the transaction, and (4) arranging for the performance of any such function."

respect to the fair competition concerns, Rule 11a2-2(T) aims to put member and non-member money managers on the same competitive footing by allowing exchange members to continue to handle orders for managed accounts if they arranged for others to perform the actual execution of the transactions on the floor of the exchange. The rule requires that orders for transactions in covered accounts must be transmitted from off the floor of the exchange and the initiating member must not participate in the execution of the transaction in any way that involves the member's presence on the exchange floor. In this way, the member's purported competitive advantages of time and place arising from direct access to the floor are reduced. The initiating member can perform clearing and settlement functions if these do not involve floor activity.

With respect to the conflicts of interest concern, the Commission noted in 1977:

> "Many conflicts of interest cannot ultimately be eliminated; and the virtues of particular conflict regulation may, over time, become a stalking horse for those with hidden economic interests. In the final analysis, it is often not possible to regulate conflicts while accommodating diverse factual situations except by relying to a great extent on full disclosure." [28]

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[28] Securities Exchange Act Release No. 13388 (March 18, 1977), 42 FR 16745.

Consistent with this view, Rule 11a2-2(T) imposes disclosure requirements on affiliated brokers that receive transaction-related compensation in connection with effecting a trade for managed accounts. Although the Commission recognized that receipt of transaction-related compensation raised conflicts of interest concerns, the Commission observed that "there are likely to be circumstances in which those authorized to transact business for discretionary accounts may find it more costly, or otherwise not in the best interest of the account, to pay separately for money management and brokerage." [29] Accordingly, Rule 11a2-2(T) permits an initiating member to receive such compensation if the person authorized to transact business for the account has expressly authorized, by prior written agreement, the member to retain compensation in connection with effecting transactions for the account. This provision was referred to as the "contract-out clause."

In order to alert managers to the potential conflicts of interest resulting from the receipt of commissions, the Rule also provides that affiliated brokers receiving such compensation must furnish a written report to the accounts' managers at least once a year setting forth the total amount of compensation retained by the broker. Such disclosure gives the account manager an

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[29] Securities Exchange Act Release No. 14563 (March 14, 1978) 43 FR 11554.

opportunity to review commission costs and determine whether the account's interests are properly served.

C. Related Statutory Provisions

At the same time that the Congress was determining the future direction of the securities markets, it was creating the Employee Retirement Income Security Act of 1974 ("ERISA"), which also addressed the combination of money management and brokerage in the case of private employee benefit plans. [30] Under ERISA, potential conflicts are addressed by combining the common law fiduciary principles of the "prudent man" [31] with statutory prohibitions on self-dealing. [32]

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30 29 U.S.C. 1106 (1985).

31 The common law notion of fiduciary obligations was articulated by Judge Cardozo in Meinhard v. Salmon, 249 N.Y. 458, 464 (1928):

> A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

32 See sections 404 and 406 of ERISA, 29 U.S.C. 1104 and 1106 (1985).

In particular, Section 406 of ERISA prohibits fiduciaries from causing the plan to pay itself a fee for services such as brokerage. This prohibition applies to affiliates of the fiduciary. The statute, however, grants the Department of Labor ("DOL") authority to grant exemptions, including class exemptions, to this prohibition. Pursuant to this authority, after the enactment of Section 11(a) and Commission adoption of Rule 11a2-2(T), the DOL adopted a disclosure-based class exemption to ERISA's self-dealing prohibition for affiliated broker-dealers. [33]

DOL's most recent class exemption in this area, adopted in 1986, allows affiliated brokers to execute orders for employee benefit plans if, among other things, the broker receives prior written authorization from a plan fiduciary independent of the broker. The broker must thereafter notify the plan that the authorization is terminable at will. The broker also must send the authorizing person confirmations disclosing the commissions received, or quarterly statements disclosing these commissions and the amount paid by the broker to others to execute these trades. Finally, the broker must send the authorizing person an annual statement summarizing the information on the confirmations or quarterly statements, and providing information on portfolio turnover and the use of brokerage commissions to pay for investment

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[33] Prohibited Transaction Exemption 79-1, 44 FR 5963 (Jan. 30, 1979).

research services.[34] These requirements for dealings with employee benefit plans parallel and supplement the authorization and disclosure requirements of Rule 11a2-2(T).

The federal securities laws also contain other provisions addressing self-dealing by certain fiduciaries. Section 17(a) of the Investment Company Act of 1940 (the "Company Act") limits self-dealing by generally prohibiting affiliated persons of an investment company or principal underwriters of a registered investment company's securities from selling securities, other than the investment company's securities, to, or buying such securities from, the investment company unless the Commission grants an application for an exemption pursuant to Section 17(b) of the Company Act. The application must show, among other things, that the terms of the transaction are fair and reasonable and do not involve overreaching by any party, and the transaction is consistent with the policy of the investment company as disclosed in its registration statement. Section 36 of the Company Act authorizes the Commission to bring actions against fiduciaries of investment companies for breaches of fiduciary duty. Section 36 also grants a private right of action to security holders of investment companies for breaches of fiduciary duty by the money managers of the fund or affiliated persons of the money manager.

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[34] Prohibited Transaction Exemption 86-128, 51 FR 41686 (November 5, 1986).

Section 17(e)(2) of the Company Act limits the commissions received by an affiliated broker acting as agent for a registered investment company to "the usual and customary broker's commission," if the trade is executed on an exchange. Rule 17e-1 under the Company Act establishes procedures to be followed by the board of directors of an investment company in determining whether a commission complies with the statutory requirement. These procedures include a quarterly review of commissions paid to affiliated brokers. Thus, registered investment companies are subject to a requirement of reviewing the fairness of commissions that is independent of the Rule 11a2-2(T) commission disclosure requirement.

C. Current Practices

In 1979, the Commission surveyed exchange members that provided money management or brokerage services to institutional accounts over which they exercised investment discretion to determine the impact of Section 11(a) and Rule 11a2-2(T) on such members.[35] Of the eighty-four firms that had provided brokerage services to covered accounts prior to 1975, sixty-five were still providing brokerage to some extent to their covered accounts in 1979. Sixty-one of these firms said they used Rule 11a2-2(T) to comply with Section 11(a). Most firms said that they derived their revenues from managed accounts from both money management fees and

35 Securities Exchange Act Release No. 16406 (Dec. 5, 1979).

brokerage commissions.[36] In most cases, Rule 11a2-2(T) allowed managed accounts to continue to direct orders through affiliated brokers.

Of the 15,596 investment advisers registered with the Commission as of June 1990, 1551 advisers indicated on their Form ADV filings that they both exercised investment discretion and were registered as, or affiliated with, a broker-dealer. Many of these broker-dealers were organized solely to underwrite shares in affiliated investment companies. Of the twenty largest registered investment advisers in 1990 (based on assets under management),[37] only 7 were affiliated with broker-dealers engaged in a general securities business.[38] A number of these largest advisory firms,

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[36] The results of the survey were released in December, 1979. The firms that derived a substantial percentage of their revenues from brokerage commissions also tended to have the smallest involvement in the management business. In fact, most of these firms derived less than five percent of their gross revenues from money management activity. Finally, with the exception of some New York-based regional firms, regional and smaller firms tended to manage smaller accounts and thus tended to derive a larger proportion of their compensation from managed accounts in the form of commissions.

[37] The largest advisers were determined by the total amount of assets each has under management as most recently reported on Form ADV, Part I, Item 18B. The largest firm was Fidelity, with approximately $100 billion under management. The 20th largest was Transamerica Fund Management Co., with approximately $21 billion under management.

[38] These firms include Prudential-Bache Securities; Donaldson, Lufkin & Jenrette, Inc.; Merrill Lynch, Pierce, Fenner, & Smith Inc.; and Shearson, Lehman, Hutton, Inc.

such as Capital Research & Management Co. and College Retirement Equities Fund, are almost exclusively money managers, although they may have affiliated brokers organized solely to distribute their own fund shares. Some of these firms, such as Fidelity, have discount brokerage subsidiaries designed to do business with the public, as well as with their affiliated funds and money managers.

It appears that, although institutional commission rates have continued to decline since 1975, [39] the use of affiliated brokers by managed accounts today is similar to that observed in 1979. In particular, Rule 11a2-2(T) has allowed money managers to select their brokers based on their assessment of the quality of executions and other services provided by that broker and the commissions charged, without regard to whether that broker is affiliated with the manager. As a result, a wide variety of brokerage allocations have emerged.

In order to obtain background information on current brokerage allocation practices, the staff spoke informally with twenty-one large investment advisers that are either broker-dealers or affiliated with broker-dealers. The staff sought information on

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[39] Large institutions currently pay about 50% less then pre-1975 rates, or about 8-10 cents per share. Commission discounts increase with the volume and size of the trades. Average discounts have fallen consistently since 1975. In fact, some brokerage firms claim institutional discounts are now too large and may result in smaller trades being unprofitable for these firms. Greenwich Reports, supra n. 22 at 14.

the extent to which these money managers direct orders to affiliated brokers pursuant to Rule 11a2-2(T). The discussions of current practices contained herein reflect the staff's analysis of the managers' responses.[40]

It appears that most money managers use their affiliated brokers to handle some, but not all, of their orders from managed accounts subject to Section 11(a). In some cases the affiliated broker-dealer will receive the large majority of orders from the managed account. More commonly, the affiliated broker-dealer will receive a small percentage of orders. For example, Fidelity has said that it uses its affiliated broker to handle less than 20% of its trades. In other cases, investment managers choose not to direct any managed account orders to their affiliated brokers, despite the exemption provided by Rule 11a2-2(T).

A money manager's decision whether to use an affiliated broker in a transaction is influenced by a number of factors. A major factor is the manager's perception of the quality of the transaction service that will be provided by the affiliated broker. Another factor is the direction of orders by the manager, and the client, to brokers to compensate them for research and other services that they provide to the manager or the client. In addition, some managers avoid using affiliated brokers in order to maintain their reputation for independence and to avoid any

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[40] A list of the firms contacted is attached to this report.

appearance of a conflict of interest. Some managers do not even request authorization from their managed accounts to pay commissions to affiliated brokers to avoid suggesting this potential conflict of interest.

III. DISCUSSION

The effect of eliminating the managed account provision of Section 11(a) must be analyzed in light of the current operation of Rule 11a2-2(T). Eliminating this provision could have an impact in three areas: the costs to affiliated broker-dealers of complying with Rule 11a2-2(T); the use of affiliated broker-dealers by managed accounts; and the protections against conflicts of interest, including disclosure of such conflicts.

A. Costs

The elimination of the managed account provision of Section 11(a) would reduce to some extent the transaction costs for member firms in effecting orders for managed accounts. Based on a survey of ten members, the Securities Industry Association ("SIA") estimated that, in the absence of the managed account provision of Section 11(a), member firms would have saved, in the aggregate, $212.5 million in 1987. [41] A substantial portion of these costs

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[41] Letter from Sheree F. Levine, Assistant General Counsel, Securities Industry Association to Robert L.D. Colby, (continued...)

consisted of brokerage fees paid to unaffiliated floor brokers used to execute the orders for managed accounts. [42]

Elimination of the managed account provision of Section 11(a) also would reduce somewhat the administrative and compliance burdens for money managers. Among other things, affiliated money managers would not have to determine the Section 11(a) status of their various managed accounts, indicate to their trading desks whether a particular order or percentage of an order was for a covered account, or respond to floor broker questions regarding the status of these orders. Also, money managers would no longer be required by Rule 11a2-2(T) to maintain the compensation records concerning managed account orders or make the annual report pursuant to that Rule. [43] Money managers also incur costs from monitoring compliance with Section 11(a). Cost savings in this area are difficult to estimate, though the SIA claims an annual $10,000-50,000 savings per affected firm.[44]

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[41](...continued) Chief Counsel, Division of Market Regulation, SEC (Oct. 11, 1989).

[42] NYSE 1989 Fact Book; NYSE Marketing Research Report (January-September 1989). Volume levels, of course, are considerably lower now than in 1987.

[43] Such information would still be required for accounts covered by ERISA unless specifically exempted by DOL.

[44] Letter from Robert C. Pozen, General Counsel, Fidelity Investments to Robert Colby, Chief Counsel Division of Market Regulation, SEC, forwarding the September 21, 1987 SIA survey results (Feb. 12, 1988).

Section 11(a) and Rule 11a2-2(T) also create indirect costs for affiliated brokers. For instance, because affiliated managers often aggregate orders subject to Section 11(a) with non-Section 11(a) orders, the entire order must be executed by an independent floor broker to comply with the Rule and avoid competition between orders from the same firm. Consequently, the floor broker must be paid a commission on the entire order. The broker also has costs of monitoring compliance with the Section.

Thus, it appears probable that eliminating the managed account provision would reduce costs for some affiliated brokers of money managers. A significant portion of the cost savings to affiliated brokers would be reduced floor brokerage costs, arising from reducing or eliminating the use of independent floor brokers to execute orders from managed accounts. [45] In present volume conditions, it appears that many exchange members have sufficient in-house floor brokerage capacity to execute at least some of the orders that are currently being handed-off to independent floor brokers pursuant to Rule 11a2-2(T).

B. Use of Affiliated Broker-Dealers

Although elimination of the managed account provision of Section 11(a) would remove the statutory restriction on the use of

[45] Currently, there are 121 independent floor brokers on the NYSE and 36 on the Amex.

affiliated brokers to execute orders for managed accounts, it is unlikely that managed account use of affiliated brokers would increase significantly in light of the conditional exemption already available for this activity in Rule 11a2-2(T). As discussed previously, it does not appear that the use of affiliated broker-dealers is limited by Rule 11a2-2(T) restrictions, but rather by other largely unrelated factors, including a desire to obtain research and avoid appearances of conflicts of interest.

Some investment advisers have expressed concern that, if the managed account provisions of Section 11(a) were eliminated, they might be required by their fiduciary obligations to form a broker-dealer affiliate. It appears unlikely that any reduction in costs resulting from the use of affiliated brokers would be significant enough to obligate money managers to affiliate with broker-dealers in order to reduce costs to beneficiaries. Given that Rule 11a2-2(T) currently allows affiliated broker-dealers to effect orders for advised accounts and thereby offer reduced commissions to managed accounts, the elimination of the managed account provision would seem to have, at most, a marginal impact on the investment advisers' fiduciary responsibilities concerning use of affiliated broker-dealers. Also, as noted previously, obtaining the lowest possible commission rate is only one factor in determining whether a fiduciary has met its duty of best execution. Nonetheless, these fiduciary concerns could be addressed by including a statement in the legislative history accompanying an amendment of the managed account provision indicating that this amendment was not intended to alter the fiduciary obligations of an investment adviser concerning affiliation with brokers.

C. Conflict of Interest and Disclosure Provisions

In view of the operation of Rule 11a2-2(T), the elimination of the managed account provision of Section 11(a) would not significantly increase the potential for conflicts of interest, other than conflicts arising from the receipt of compensation for effecting orders. Exchange member brokers with affiliated managed accounts would continue to have the potential for conflicts of interest when the member handled orders on the floor for both its affiliated accounts and other unaffiliated accounts.

The Rule only incidentally limited conflicts in effecting trades for managed accounts by requiring the ultimate execution to be completed by an independent floor broker on the exchange floor. By adding a level of independence at the point of execution, the Rule reduced the likelihood that managed account orders would receive special treatment at execution. This potential conflict, however, was never considered of primary importance. Moreover, the potential for a much more significant conflict of interest, that of broker-dealers trading ahead of their customer orders to benefit from price effects, is not addressed by either Rule 11a2-2(T) or Section 11(a) itself.

Rule 11a2-2(T) does address, in part, other potential conflicts arising from the receipt of transaction-related compensation for effecting trades for managed accounts. Rule 11a2-2(T) currently prohibits receipt of this compensation unless the managed account specifically authorizes this compensation by written contract, and the affiliated broker provides an annual statement of the amount of compensation retained for execution of orders for the specific managed account.

These conditions were intended to provide protection against conflict of interest abuses by requiring consent from and disclosure to the authorized persons of the managed account. Fiduciaries for managed accounts generally will authorize the payment of commissions to affiliated brokers, if authorization is requested. Some managers do not seek this special authorization, however, to avoid perceptions of conflicts of interest arising from their affiliation with a broker. This reluctance suggests that requiring authorization may continue to be useful in alerting the authorized persons of managed accounts to the potential conflict arising from the combination of money management and brokerage.

The annual compensation disclosure statement required as a condition of Rule 11a2-2(T) is intended to inform the managed account of the extent of its commission business involving the affiliated broker, as well as the amount of commissions paid by that broker to unaffiliated floor brokers. Similar commission disclosure is required independently for transactions by affiliated brokers for employee benefit plans and registered investment companies. Although the value of this disclosure largely depends upon the review that it receives from the managed account, the mandatory delivery of this information may serve to remind that account of the potential for a conflict, and stimulate review by that account of the extent of its use of the affiliated broker. The elimination of this requirement would allow affiliated brokers to stop reporting compensation information in the form specified by Rule 11a2-2(T); affiliated brokers of employee benefit plans and investment companies, which continue to have disclosure obligations under ERISA and the Investment Company Act, respectively, would still have to disclose affiliated broker compensation, thus limiting the cost savings from eliminating the Rule 11a2-2(T) requirement.

IV. CONCLUSION

In its testimony in 1975 on Section 11(a), the Commission cautioned against setting inflexible limitations on execution of orders for affiliated accounts, in view of ongoing market changes. The demise of fixed commission rates concurrent with adoption of the 1975 Amendments, the broadening of exchange membership, and the increased access to current quote and trade information and electronic order routing systems have significantly reduced the advantages to money managers of affiliation with a broker-dealer.

Accordingly, Rule 11a2-2(T), which was premised on market changes already underway at that time, removed most of the Section 11(a) impediments to effecting orders of managed accounts through affiliated brokers. Elimination of the managed account provision of Section 11(a) would move beyond Rule 11a2-2(T), however, by not requiring the ultimate execution of managed account orders by independent brokers, and by obviating the authorization and disclosure requirements for retaining compensation for effecting these orders. Elimination of these provisions would appear to reduce costs somewhat for affiliated brokers executing orders for managed accounts, without significantly changing the extent that money managers would use affiliated brokers.

The requirement that specific authorization be obtained from managed accounts before an affiliated broker can retain any compensation appears to have some value by causing the authorized person of the account to focus on the possibilities for conflicts of interest. Similarly, annual disclosure of affiliated broker compensation can have a similar effect on an ongoing basis. Therefore, retention of these requirements, by statute or rule, may be of value.

Accordingly, the Division of Market Regulation recommends that the Commission support elimination of the managed account provision of Section 11(a) of the Exchange Act provided that the legislation also gives the Commission rulemaking authority to retain the managed account authorization and compensation disclosure requirements.