Walter Werner
Lonetown Road, Route 1
West Redding, Conn. 06896

February 23, 1968

Secretary
Securities and Exchange Commission
Washington, D.C. 20549

Re: Exchange Act Release No. 8239

Dear Sir:

This letter is being written in response to the request set forth in the subject release for expression of views on the two proposals that it presents.

1. <u>Proposed Rule 10b-10</u>

I cannot understand the wisdom of this proposal. True, it would capture for fund shareholders the "excess" brokerage now benefiting their fiduciaries. But at what price? For the brokerage to be recaptured constitutes the illicit fruit (formerly illicit under the anti-rebate rules but countenanced under current usage) of subverting the present fixed posted minimum commission rate of the exchanges. Yet the Commission's proposal would impliedly confirm and perpetuate this subversion.

The proposal thus appears to be inherently inequitable. It would subsidize fund shareholders at the expense of exchange customers who deal directly rather than through institutional intermediaries such as the mutual funds. The proposal accomplishes this result by its division of exchange customers into two classes. Class I would consist of registered investment companies or affiliated persons of those companies (as well as other fiduciaries of pooled funds). Class II would consist of all other public customers. They would become truly second-class customers for they alone would pay the posted minimum commission rate. Class 1 would formally be recognized as an elite, for they would pay the lowest commission rates that their managers can negotiate with any exchange member. This negotiated commission for any transaction should normally be not much higher than the marginal or incremental cost incurred by the member in handling this particular transaction. As the release points out, this cost at times seems to approximate 25% of the posted commission rates.

So fund shareholders would receive a windfall. But other users of the exchanges would pay for this windfall. These other users, i.e., Class II, would be paying a disproportionate share of the cost. E.g., if Class II were to transact 60% of

exchange volume, it could pay as much as 90% of the charge for all exchange volume. This is 50% more than the commission they would pay if the costs were distributed evenly among all exchange customers. Since Class II includes all individual customers, round lot and odd lot; who trade directly on the exchanges, these customers would pay a 50% surcharge to defray most of the costs of members of the public who invest in stocks through institutional intermediaries. The public policy or logic of such a proposal is certainly not made clear by the subject release.

The proposal is troublesome on other grounds. It confirms an existing exception to the fundamental principles of any minimum rate structure not because the exception is fair or reasonable but only because the exception, compelled by the obvious inequities of the present commission structure, now exists. The NYSE proposal possesses the virtue of attempting to eliminate the conditions that gave rise to the exception in the first instance. The Commission takes a different route. In effect, it recognizes a malignancy in the rate structure which, at least by implication, it would continue. The Commission would merely transfer an unjustified advantage from fiduciaries who should not be receiving it to their beneficiaries. The latter's claim may be superior to that of the fiduciaries but still does not justify the malignancy in the first place. The NYSE proposal contemplates a course that the Commission itself has publicly advocated: to take action to excise the malignancy.

Finally, the proposed rule would be exceedingly difficult to police. The subject release recognizes "the obscure and often devious ways" in which the commission is presently distributed among broker-dealers. The SEC proposal would spur development of methods to circumvent its objective. These methods will fail only if the SEC polices the new rule vigorously. But why should the SEC deliberately choose a route that, in addition to its other defects, calls upon it to expend its limited resources as a policeman? On this count, as well as the others discussed above, the subject release fails to establish policy considerations that may support the proposal.

2. The New York Stock Exchange Proposal

Let me make it clear that I refer to Mr. Haack's letter of January 2, I968 as a "proposal" only because the subject release does so. But the letter obviously does no more than set forth the framework or outline for a proposal, with all the flesh and content remaining to be filled in. It is therefore necessary to assume for purposes of these comments, as the Commission assumes in its release, that the specifics will be determined "in such a way that the proposal will accomplish its intended purpose."

I believe that the first, third, and fourth principles laid down in Mr. Haack's letter are salutary and, meaningfully implemented, would materially alleviate the problems described in the release.

But I do not understand the second and fifth principles. The second supports continuation of give-ups "with a limitation on the percentage amount which may be so given-up". The sole justification advanced is that this principle "would give recognition to the fact that there is more to an order than its execution." I assume that the "more" referred to here embraces securities research, investment advice or some equivalent service. But this cryptic explanation surely requires elaboration. And, even if the principle is valid, it would seem to require two limitations: (1) some reasonable equivalence between the value of the service rendered by the recipient of the give-up and the amount of the give-up, and (2) opening up the present NYSE rule to permit Exchange members to give up commissions to non-members (as well as to other Exchange members).

In the same way, I do not understand the fifth principle's restriction of future exchange membership to bona fide broker-dealers. The restriction is said to be "necessary to insure the health and vitality of our securities distribution and auction market mechanism as we know them." But the whole purpose of the Exchange's proposals, as I understand them, is to improve existing arrangements, present existence of any arrangement or structural characteristic should not, therefore, preclude examination into its feasibility or wisdom.

One final point. While Mr. Haack presents the Exchange's proposals as a "package," no reason is given why the Exchange could not adopt principles (1), (3) with SEC cooperation, and (4), without either or both (2) or (5).

I should like, in conclusion, to express my appreciation for the opportunity to comment on these proposals. It is the first such opportunity since my serious preoccupation with these problems as a member of the Commission staff several years ago. My views thus represent the opinion of one who has no personal interest in any segment of the securities industry and who firmly believes these problems can be resolved in a way that both protects the interests of investors and promotes strong and healthy securities markets.

Very truly yours,

Walter Werner