Before the
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

INQUIRY INTO

PROPOSALS TO MODIFY THE COMMISSION RATE STRUCTURE
OF THE NEW YORK STOCK EXCHANGE

SEC Release No. 8239

COMMENTS OF
THE UNITED STATES DEPARTMENT OF JUSTICE

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COMMENTS OF THE UNITED STATES DEPARTMENT OF JUSTICE

The Department of Justice respectfully submits Its comments and recommendations in response to Commission Release No. 8239. By this release, the Commission has invited "all interested persons" to comment upon proposed SEC Rule 10b-10 and upon various proposals of the New York Stock Exchange ("NYSE") to revise its commission rate structure. The Commission has also solicited alternative suggestions "for dealing with the serious problems presented" by the existing rate structure, particularly in the context of increased institutional trading.

CONCLUSIONS AND RECOMMENDATIONS

The Department intends to review closely the filings by other parties in this proceeding. On the basis of information now available, and for the reasons set forth below, the Department concludes:

1. The problems raised by the Commission's release, with regard to impact of the NYSE rate structure in institutional trading, raises a basic question about whether

rate fixing by the NYSE is required or justified by the objectives of the Securities Exchange Act.

(a) The principal objective of the regulatory law, the maintaining of an effective auction market, does not appear to justify the fixing of minimum commission rates by the NYSE. The economic characteristics of this industry, and past experience, do not indicate any significant risk of "destructive" price levels, or adverse consequences to the exchange operation, from rate competition. In fact, effective competition already occurs for the business of institutional investors. Because of the minimum rate structure, this takes the indirect form of give-ups and reciprocal arrangements; the additional problems resulting from these indirect manifestations of rate competition would not arise if bargaining could directly lower the commissions to competitive rates. Rate competition, moreover, should decrease the costs to the public and stimulate more efficient operation of the NYSE. Moreover, the complexities and difficulties involved in arriving at a regulatory standard of reasonableness which should be applicable to minimum rates if they are to be continued support the conclusion that such task should not be undertaken so long as competition is feasible.

(b) As to the objective of protecting investors, rate fixing is plainly unnecessary in institutional trading and, generally, for large transactions. But there is significant uncertainty as to the effect and feasibility of eliminating all rate fixing on smaller transactions, involving the public-at-large. This does not appear to justify the present system of minimum rates, but it is possible that maximum rates may be warranted for the protection of investors. Further exploration of a number of issues is required before action can be recommended on the need for such maximum rate regulation.

2. Revision of the NYSE commission rate structure should be accompanied by appropriate action to permit access to NYSE market by broker-dealers, not now members of the NYSE, on a fair and equitable basis. The Department is not now prepared to recommend a choice among a number of possible methods to achieve this result, and further study of these alternatives is needed.

3. The desirability of relying upon competition in commission rates, where feasible, is confirmed by analysis of the alternative proposals set out in the Commission's release. The Commission's proposed rule, requiring managers of investment companies to assure that give-ups are applied for the benefit of their companies, might be a useful supplement in a competitive market. But, standing alone, it is an indirect, and incomplete remedy to the present situation, in contrast to permitting bargaining which would directly lower commissions to competitive rates. The NYSE proposal for a volume discount would be a move in this direction, depending upon the level of the discount arrived at, but rate competition is a more flexible solution. In addition, the NYSE proposals to limit

give-ups and prohibit reciprocal practices, without at the same time assuring that rates will be set at a competitive level, are objectionable. So long as unrealistic NYSE rates continue, these practices appear to provide the only means by which at least some investors can obtain the services of NYSE member firms at a reasonable price. The practices do raise problems, but the solution is to revise the rate structure which gave rise to them.

4. Revision of the NYSE commission rate structure, and greater reliance upon competition, may have some adverse effects upon regional stock exchanges and the "third market" to the extent that these institutions depend for their success upon their ability to offer lower commissions or more flexible rules relating to commission splitting on NYSE listed securities. The possibility of such adverse consequences, however, is not a reason to put off essential reforms in the NYSE rates.

Accordingly, on the basis of present information, the Department recommends:

1 The Commission should promptly take appropriate Steps to determine the extent to which commission rate fixing by the NYSE is required by the purposes of the Securities Exchange Act. The Commission should then take action (a) to eliminate all rate fixing which is not found to be justified in the public interest; (b) to develop and promulgate standards governing the validity or reasonableness of any commission rates for which rate fixing is permitted to continue; and (c) to determine the proper means for assuring equitable and nondiscriminatory access by nonmember broker-dealers to the NYSE market.

2. In order to accomplish these objectives, the Commission should institute the hearings necessary to the resolution of such factual questions as it believes pertinent to the above issues. In our judgment much of the relevant information is already a matter of public record or can be readily assembled.

When this factual inquiry is concluded -- or earlier, to the extent that such inquiry is not needed -- the Commission should take appropriate action to confine NYSE rate fixing within such limits as are required by the Securities Exchange Act and the antitrust laws, and to enhance the access of non-member broker-dealers to the NYSE on a fair and equitable basis. The Department is of the view that, upon the information now available, the Commission could proceed to eliminate the fixing of commission rates upon transactions by institutional investors and upon other transactions above a specified dollar value (to be prescribed by the Commission); this could be supplemented by a rule requiring the responsible officials of institutional investors to obtain the benefits of competitive rates for such companies.

The Commission has applicable authority to take all the foregoing action under, inter alia, Section 10, Section 19(b), and Section 21(a) of the Securities Exchange Act.

I. THE INTEREST OF THE DEPARTMENT OF JUSTICE

The Department of Justice is interested in the pending proposals, and in the problems presented by commission rate fixing, because it has the duty to enforce the antitrust laws, and to promote the competitive policies embodied in such laws. As the Commission held more than 20 years ago, the Department is an "interested party" entitled to intervene in agency proceedings which "raise questions concerning the relationship between . . . the Exchange Act and the public policy embraced in the Federal Antitrust laws" (National Association of Securities Dealers, 15 S.E.C. 577, 581 (1944)).

Such questions are, of course, raised by this proceeding. The Commission's release (p. 1) stresses that consideration of the pending proposals and of the commission rate practices and procedures "must include careful attention to their impact upon competition, including competition among securities firms, competition among markets and competition among institutional investors". The exchange market in which securities are traded is the epitome of a competitive market. Plainly, the regulatory objectives of "just and equitable principles of trade", "fair dealing in securities", "fair administration of the exchange" and "the protection of investors" can be enhanced by competitive structure and practices. . Sections 6, 19(b), 15 U.S.C. 78f, 78s(b); The Rules of the New York Stock Exchange, 10 S.E.C. 270, 287. [Footnote: Cf., for the relevance of competition to other public interest standards of regulatory laws, Federal Maritime Commission v. Svenska Amerika Linien, 1960 CCH Trade Cases, para. 72,376 (U. S. Supreme Court); United States v. RCA, 358 U.S. 334.]

Moreover, as the Commission further recognized, "the Exchange commission rate structure includes a number of practices which would clearly violate the antitrust laws" except to the extent that immunity from those laws may be implied. Under Silver v. New York Stock Exchange, 373 U.S. 341, 357, antitrust exemption for such practices "is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary" -- this is the "guiding principle to reconciliation of the two statutory schemes," the antitrust law and the Securities Exchange Act.

The issues raised by the SEC release about the commission rate structure unavoidably present the question of the extent to which commission rate fixing and related practices by the NYSE are justified and are, consequently,

"necessary to make the Securities Exchange Act work". The regulatory standard applicable to supervise NYSE rate fixing is also at issue, since regulatory control must be pervasive and effective in order to imply antitrust exemption. [Footnote: Silver v. New York Stock Exchange, 373 U.S. 341, 359; see also Carnation Co. v. Pacific Westbound Conference, 383 U.S. 213; United States v. Philadelphia National Bank, 374 U.S. 321, 350-351.] Resolution of these fundamental questions concerning the present structure, and the proposed revisions, is of direct concern to the Department of Justice since the ambit of its enforcement powers will be directly affected. [Footnote: We note that the Seventh Circuit's decision in Kaplan v. Lehman Brothers, 371 F. 2d 409, certiorari denied, 389 U.S. 954 (Warren, C. J., dissenting), suggested that antitrust jurisdiction has been superseded in this area. But that case involved a complaint that NYSE rate fixing should be held illegal per se, that is, without analysis of justifications or defenses was required (250 F. Supp. at 562; 371 F. 2d at 409). As the Commission there urged in its amicus filing, such a per se rule "obviously would restrict the Commission's regulatory jurisdiction if it was subsequently determined that a fixed minimum rate was indeed necessary in whole or in part to carry out the purposes of the Exchange Act." (SEC Brief in C.A. 7, No. 15663, pp. 26-27, emphasis added.) The ruling in Kaplan, especially in the absence of any plenary review by the Supreme Court, did not foreclose the need for resolution of the application of Silver in this context, in order to determine the scope of antitrust jurisdiction. Cf. Kaplan v. Lehman Brothers, 389 U.S. 954, 957-958 (Warren, C.J., dissenting against denial of certiorari).]

II. THE OBJECTIVES OF THE EXCHANGE ACT DO NOT APPEAR TO REQUIRE OR JUSTIFY RATE FIXING BY THE NEW YORK STOCK EXCHANGE, EXCEPT FOR THE POSSIBILITY OF A NEED FOR MAXIMUM RATE FIXING TO PROTECT INVESTORS; RATE COMPETITION SHOULD BE RELIED UPON WHERE FEASIBLE, AS IT CLEARLY IS FOR INSTITUTIONAL INVESTORS AND LARGE-BLOCK TRANSACTIONS .

The present proceeding is directly concerned with aspects of the rules of the NYSE dealing with commission rates which date back to the celebrated Buttonwood Tree Agreement of 1792. The basic provision of the NYSE rate structure is the prescribing of a flat rate fixed minimum commission to be charged by NYSE members on all exchange transactions. At present the minimum rate is graduated according to the value of a round lot (100 shares), with larger quantities paying a multiple of the round-lot commissions; there is no volume discount. Thus, for example, the commission payable varies only with the price per share.

Sales Price per Share: $10.00
Commission on 100 Shares: $17.00

Commission on 1,000 Shares: $170.00

Sales Price per Share: $40.00
Commission on 100 Shares: $39.00
Commission on 1,000 Shares: $390.00

Sales Price per Share: $70.00
Commission on 100 Shares: $46.00
Commission on 1,000 Shares: $460.00

Sales Price per Share: $100.00
Commission on 100 Shares: $49.00
Commission on 1,000 Shares: $490.00

A related aspect of the rate structure is that a very considerable degree of rate preference given to NYSE members as opposed to nonmembers (both nonmember broker-dealers and the public), for the service of executing and clearing transactions. [Footnote: This preference and its effects are discussed in Part III, infra.]

The question is whether these practices, which long predate the Securities Exchange Act of 1934, are in fact essential to the NYSE's functions under the Act, and are "necessary to make the Securities Exchange Act work". To the extent they are not, then the practices will not be protected from the operation of the antitrust laws (see Silver v. New York Stock Exchange, 373 U.S. 341), and the Commission should act to eliminate them.

The problem, at the outset, may be crystallized by focusing -- as does the Commission's release -- upon operation of the NYSE rate structure as regards the transactions of institutional investors. The Commission release indicates (and the NYSE letter of January 2, 1968 confirms), there is now no effective minimum rate for brokerage in this important and growing part of securities trading. Competition and arms-length bargaining establishes how much the executing brokers actually retain as commission, which has been reduced in some transactions to as low as 25% of the fixed "minimum" rate. And the striking point made by the Commission's release is that the problems giving rise to this proceeding do not result from the effective low commission rate produced by competition, but, rather, from the distortions imposed by the concurrent existence of a nominal fixed minimum rate.

The NYSE's fixed rate forces otherwise salutary competitive negotiations into an array of devices and practices which raise serious questions of regulatory policy. Being prevented from simply obtaining a discount from the member firm, the institutional investor, directs payment of the excess commissions to designated

persons, who must come within the classes permitted to share in commissions by the rules of the particular exchange (in the NYSE, member brokers only); or directs other forms of remittance to designated persons, as by sending to them reciprocal commission business or other transactions. Some of the negotiated reductions in commission have been diverted for the private benefit of institutional managers, in violation of their fiduciary responsibilities. In any event, the reductions are commonly distributed for services unrelated to the particular transactions, such as for the sale of mutual fund shares.

The desire to obtain advantageous terms for give-ups and reciprocal business has led to shifting of transactions to exchanges other than the NYSE, and carrying out these arrangements has shifted transactions to firms designated for that purpose. This tends to distort the choice of brokers by which, and the markets in which, transactions are to be executed. It also distorts the institutional investors' choice of firms who perform other services, since they would tend to favor those who can be rewarded by means of give-ups and reciprocal business. [Footnote: There are also other consequences which are inconsistent with the policies of the Act. Irrational discrimination is created between transactions of the same size and nature, since give-ups and reciprocal arrangements can be utilized by mutual funds much more readily than other institutions or persons. Also, membership on exchanges is sought by institutions which have no interest in performing any floor trading or brokerage services, only in order to avoid excessive charges, which has led to the introduction of artificial barriers to such membership. And the paying for other services by means of give-ups leads to difficulties in assuring adequate disclosure by investment companies.]

The NYSE, in its filing in this proceeding, asserts that give-ups are justified because they are "a highly flexible means of compensating various brokerage firms for different constructive services," which enhance "investment performance"; and because the brokers who sell funds and perform other services "can justifiably expect" brokerage business as part of "a bond of mutual interest" (NYSE filing, pp. 6, 8-9). But the elimination of the need for give-ups would not hamper the investment funds. Rather, it would free them to choose firms for different services on the merits, and to pay directly for such services. Moreover, the NYSE's whole-hearted defense of reciprocal dealings runs counter to antitrust policy which has condemned reciprocity as an "irrelevant and alien factor" in the marketplace, threatening to exclude firms for reasons unrelated to the price and quality of their goods or services. Cf. Federal Trade Commission v. Consolidated Foods Corp., 380 U.S. 592, 594; United States v. General Dynamics Corp., 258 F. Supp. 36 (S.D.N.Y.).

In our view, the growth of institutional trading has provided an instructive testing ground for the NYSE commission rate structure and its consistency with the purposes of the Securities Exchange Act. The experience demonstrates that the

present rate structure is unsupportable. The NYSE's prescribed minimum commission rates are far too high, at least for large volume transactions, and this has led to a substantial diversion of institutional business to other markets. Moreover, the experience also shows that rate competition may be a feasible alternative. The process of competitive bargaining has worked to arrive at reasonable rates satisfactory to the institutional investor and to the broker handling the transactions.

Accordingly, while revision of the existing rate structure is plainly required, the developments in institutional trading raise the more fundamental question whether any commission rate fixing by the NYSE is justified. We turn, therefore, to an appraisal of the need for NYSE rate fixing to achieve the public interest objectives in the operation of a securities exchange -- (a) the maintenance of an effective auction market; and (b) the protection of investors.

A. Commission Rate Fixing Does Not Appear to Contribute to the Performance of the NYSE as an Auction Market

The first and principal public interest in the operation of a securities exchange is to provide an efficient auction market. The openness of such a market is a particular advantage because it enables investors to follow closely the course of business, and place a value on their listed securities at any particular moment in time. The market should facilitate rapid and efficient adjustments and transactions. It should have sufficient depth or liquidity to maximize the likelihood that both sides of a transaction will be available, and to prevent disruptive price fluctuations in response to relatively small variations in supply and demand.

Securities exchanges should be expected, in fact, to approximate the economic model for a perfectly functioning market In all essential respects, in contrast to many industrial markets where time lags, technological factors and other limitations may exist. [Footnote: These characteristics of such a market would include: (i) it would be open to a large number of buyers and sellers; (ii) it would provide all market participants with open access to information; (iii) it would facilitate rapid adjustments and transactions; and (iv) it would minimize the costs of transactions. See, e.g., G. J. Stigler, The Theory of Price (MacMillan 1967 ed.).] Yet the NYSE falls considerably short of the model in several important respects. To start with, the existing rate structure creates an economic incentive for institutional investors and nonmember broker-dealers to take transactions to other markets, since it lacks volume discounts or discounts to nonmember broker-dealers. [Footnote: The problem of rates charged nonmember broker-dealers is discussed in Part III, infra.] And the existence of any fixed minimum rate above the competitive level will necessarily have such adverse effect.

It is not altogether surprising that the NYSE rate structure falls short of economic theory. It is a product of history, not logic or necessity. It was first developed to serve the private advantage of the exchange members, and has managed to survive into an age in which private rate fixing is illegal under the antitrust laws and the exchange has been charged with public responsibilities and subjected to public regulation.

In its filing in this proceeding, the NYSE seeks to justify fixed minimum rates on the ground that any inroads into the system would foster "destructive price competition" in a basic industry endowed with a special responsibility for natural economic well-being." Price competition, it is claimed, would be "ruinous" and would threaten "the continued solvency of member organizations" (pp. 3-4). [Footnote: The NYSE filing also contends that elimination of fixed commission rates would cause the quality of service to decline. We deal with that contention in Part II (B), infra.] What this amounts to is an argument that NYSE members must be guaranteed a reasonable return on commission business, in order to enable the exchange to perform its function as an auction market.

In the first place, the NYSE argument echoes the plaints repeatedly rejected, whenever advanced, in many other sectors of our economy. As the Supreme Court stated in the leading case on price-fixing under the antitrust laws, United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 221, "such defense is typical of the protestations usually made in price-fixing cases. Ruinous competition, financial disaster, evils of price cutting and the like appear throughout our history as ostensible justifications for price-fixing." These claims have been unequivocally rejected by the courts as "wholly alien to a system of free competition". To be sure, the securities industry is regulated and the Commission has the power to determine the reasonableness of the commission rates fixed by the NYSE membership. But this does not of itself demonstrate that such rate fixing by the NYSE is necessary for the effectiveness of the exchange as an auction market. The claim of "ruinous competition" cannot be accepted as justification without specific showing that this industry -- unlike others -- is one in which competition is not feasible and is likely to damage the public interest.

In fact, there is no reason to expect that rate competition would reduce commission levels to a point which would not cover costs and a reasonable profit. The danger of "destructive" pricing has been generally regarded as significant enough to warrant minimum rate regulation only in industries characterized by high fixed or overhead costs. In those situations, competitive pricing may tend to drive prices, towards incremental out-of-pocket cost levels, and this could have the "destructive" effect on all companies of eroding the capital base needed for operations in the public interest. [Footnote: Bonbright, Principles of Public Utility Rates, pp. 368-406 (Columbia University Press, 1961); Phillips, The Economics of Regulation, (Richard D. Irvin, Inc., 1965).] But this

consequence is properly not of concern in most industries, where variable costs predominate, and there is no ground for concern here. There are not large overhead or fixed costs associated with brokerage operations, and there do not appear to be significant incentives for brokers to provide non-compensatory services for any customers. The fact that competition can produce reasonable return on brokerage services without leading to widespread loss operations is confirmed by the experience in institutional trading, where the effective rates are quite low, but no suggestion of "ruinous" consequences has been advanced.

Nor is the brokerage business in any sense a natural monopoly, the other principal situation in which rate regulation has been found appropriate because competition is not feasible. [Footnote: See authorities cited in preceding note.] The NYSE now has over 600 member firms and more than 350 of these firms carry customer accounts. There is also no evidence in the brokerage business of economies of scale of sufficient magnitude which would threaten to drastically reduce the number of member firms in the future. Prior investigations of the Department indicate that about 20 member firms have accounted for almost half the commissions paid on NYSE transactions, but that the profitability of member firms was not merely a function of the volume of trading handled and that some small volume operations were quite successful. Firm profitability tends to depend on both skill in trading and efficiency, including the efficiencies made possible by automation, which are becoming more readily accessible to operations of varying sizes. Moreover, the public interest is advanced, not impaired, by competition which rewards the skilled and efficient at the expense of others. Even if some of the latter firms are required to withdraw, the skilled and efficient may enter [Footnote: See, e.g., "Stock Market Mavericks -- Two Analysts Build a Firm on Research and Telling Salesmen Just What to Push", Wall Street Journal, March 28, 1968, p. 34.]; and there is no reason to fear that rate competition is inconsistent with the continued viability and effectiveness of the number and diversity of firms needed for optimal operation of the exchange. [Footnote: Apart from the proper functioning of the exchange market, there is also concern about the losses imposed upon individual customers by the failure of a member firm. But that problem exists now. Commission rate-fixing does not assure the profitable survival of particular member firms, since there is no assured retention of customer accounts and, more important, there is no "stabilization" of other aspects of the firms' businesses similar to the minimum commission. Protection of customers from losses due to failure of particular member firms requires a different approach -- involving, for example, capital requirements, fiduciary restrictions and procedures to regularize the pooling of losses or other insurance techniques. Cf. Federal Deposit Insurance Act, 12 U.S.C. 1811-1855.]

The efficient operation of the NYSE, and lower commission rates reflecting it, would also enhance the attractiveness of this market to the investing public. It must be remembered that the risk of "thinness" of the NYSE market is not a

function of the number of member firms executing or clearing trades. Rather the effectiveness of the Exchange market depends upon maximizing the volume of transactions brought to it, an objective which has not been served by the minimum rate structure. Moreover, the principal effect of a tendency towards more efficient floor activities at a lower rate, would be to separate the charges for executing and clearing transactions from those for investment advice and other ancillary services. Even if fewer firms performed the clearing functions, which are susceptible to automation, the latter services could be rendered by a wide variety and large number of brokerage firms. This would appear to serve the public interest since, as with other pending reforms (e.g., automation of odd-lot trading), the investing public can have the benefit of efficient functioning of the NYSE without foregoing diversity of sources of advice and other services.

Finally, it should be recognized that if assuring NYSE members a reasonable return from commission business were to be accepted as a justification for fixed or minimum commissions, it would then be necessary to formulate a standard of reasonableness against which the returns provided to member firms by the NYSE rates could be measured. The Commission would have to examine detailed information on the commission revenues and the costs attributable to doing such business. The latter costs would have to be separated from the costs of other aspects of member firms' operations -- e.g., as brokers in over-the-counter transactions; as underwriters; as agents for sales of mutual fund shares; as dealers trading for their own accounts. Perhaps it would also be necessary to eliminate all activities as an investment adviser. And it would be essential to allocate portions of overall firm costs, such as partners' salaries, research or information departments, etc., to the public commission business.

On the basis of these data, it should then be possible to determine the present level of profitability for various firms, and the average volume-of trading required at existing rates to sustain operations as broker to the public-at-large. This may be difficult to ascertain, because member firms are so disparate in size, efficiency and in the mix of services provided, and because it would be difficult to find the compensation levels justified as required to bring the needed talent into the brokerage business. But the Commission would then have to go further, since there is an unavoidable relation between such data and the number and scale of member firms which would be appropriate. Clearly, progressive increases in rates could sustain inefficient and smaller scale operations of a large number of firms. The Commission cannot be expected to assume a need to compensate adequately an expanding number of member firms, or for that matter all now-existing member firms, without a determination of their contribution to the effectiveness of the exchange market.

Thus, prescribing a reasonable return for the purpose of keeping up the number of member firms would involve the Commission in complex and difficult

determinations -- separating and allocating costs in a way which may be unrealistic as a matter of business practice; and relating the return on commission business to some optimum distribution of member firms. If rate fixing were retained for the purpose of protecting members' revenues, this task would have to be undertaken. But it is apparent, we believe, that it should not be undertaken so long as competitive pricing is a feasible alternative. [Footnote: We suggest below that prescribing a fixed or maximum commission rate might possibly be justified and required under the Securities Exchange Act to protect small investors from excessive or inequitable charges, for which purpose competition may not be effective. This objective would involve some of the regulatory problems above described, but not all, since the limited purpose will be protection of investors, not the protection of members' revenues.]

B. Protection of the Investing Public May Possibly Justify Commission Rate Fixing on Transactions of Small Investors

The second important criterion of exchange operation pertinent to the commission rate structure is the protection of the investing public. This policy is expressed in the various prohibitions against manipulative devices and deceptive practices. The Act also requires that the rules of registered securities exchanges be adequate "to protect investors" (Section 6(d), 15 U.S.C. 78f(d)), and empowers the Commission to modify exchange rules when "necessary or appropriate for the protection of investors" (Section 19(b), 15 U.S.C, 78s(b)).

The most obvious interest of the investing public in this regard is to be protected from excessive commission charges. This is plainly not an objective served by the existing NYSE rate structure, which prescribes only a minimum rate and prevents competitive price reductions. It is an objective which would be promoted by the fixing of a maximum rate. The question is whether rate fixing for that purpose is required.

Rate fixing to prevent excessive charges is plainly unnecessary insofar as the institutional investor is concerned. As we have seen, such investors have been quite capable of obtaining lower effective brokerage rates from the NYSE firms handling their transactions; and the same would presumably be true for other investors trading large blocks of securities if fixed rates were eliminated and competitive rates were directly available to customers. We note only that the Commission may find it desirable to supplement the competitive market by promulgating a rule requiring investment company managers to seek to obtain the lowest available commission rates (see Point IV, infra).

The argument that rate regulation is necessary to prevent undue charges may be more plausible with respect to the small investor, whose purchases and sales still make up more than half of the trading on the NYSE. On the one hand, it is by no

means compelling; indeed, it may be argued that there are a sufficient number of competing brokerage firms to keep commissions at reasonable levels without prescription by the NYSE or regulation by the Commission. The fact that NYSE's last rate increases, adopted in 1953 and 1958, were opposed by a substantial proportion of its members, suggests that a substantial proportion of the brokerage community was willing to offer the public generally lower rates. This in turn suggests that competitive rate making would have provided lower rates.

On the other hand, the small investor does not have effective bargaining power, comparable to the institutional traders. He also may lack important information about the prevailing rates, and about available alternatives. Moreover, brokers may have little incentive to compete in rates to the general public, as shown by the fact that over-the-counter rates follow NYSE rates despite absence of a fixed minimum. [Footnote: Over-the-counter securities dealers are subject to a maximum prescribed by the National Association of Securities Dealers under the Maloney Act (15 U.S.C. 780-783).] On the NYSE, moreover, in contrast to other service markets, the members are in such close association that there is likely to be a tendency towards tacit understanding. This is especially true because the brokers' clearing services on small trades are so fungible that a discount by any significant minority would force all rates down. In the circumstances, it may be preferable to have the NYSE fix rates and the Commission regulate them, rather than to depend upon competition. [Footnote: Need for regulatory supervision may be supported by the fact, pointed out in the NYSE filing, that commission rates represent a small proportion of the amount of capital involved in securities transactions, or expected to be earned on successful investments. Yet the aggregate of NYSE commission payments for trading on the NYSE exceeded $1.5 billion last year. As in other regulatory situations, the individual investors have insufficient interest to effectively protect themselves by bargaining so that effective competition or effective regulation is required.]

If the latter arguments are accepted, it would be necessary, for effective regulation, to formulate a standard to be applied by the Commission for reviewing the validity of rates fixed by the NYSE, for the purpose of protecting the investing public against excessive charges. Moreover, any such purpose could be accomplished by prescribing a maximum rate, rather than by the existing practice of fixing only the minimum commission; this is what is in fact already done by the N.A.S.D. in the over-the-counter market. The Commission's Special Study recommended consideration of "the feasibility and desirability of (1) a separate schedule of rates for the basic brokerage function and for ancillary services, or alternatively (2) a schedule of maximum rates, or minimum-maximum rates, covering all services" (Special Study, Part 5, pp. 106-107).

The NYSE filing suggests, nevertheless, that the minimum rate structure might be required to protect the investing public in two ways, by promoting high-quality

service, and by preventing unduly favorable treatment of large institutional investors. Neither of those purported justifications has merit.

The NYSE asserts (pp. 3-4) that the minimum commission rate system "fosters vigorous competition in the quality of service rendered", which would decline if rate competition were instituted. But excessive prices do not provide assurance of improved service to the customer, in effect, they vest in the sellers the choice between (1) garnering higher profits, or (2) providing expanded services, or (3) being less efficient. And even if services are expanded as a result of excessive rates, the consequence may be to provide the customer with services he does not need or desire, and which he would avoid if he had the choice. The Department is familiar with economic analysis of highly concentrated oligopoly industries characterized by so-called "administered" pricing, which tend towards unusually high expenditures for such things as promotional activities and questionable product differentiation. In the securities business, as well, there is substantial evidence that the NYSE rate structure has stimulated a great deal of promotional activity, dissemination of brochures and research information, etc., the justification for which may be questioned. The effect of competitive pricing would not be to eliminate services of this type when desired. But it should lead to a more flexible system in which the investor has the choice of obtaining these ancillary services for an appropriate charge.

As to the second point, the NYSE filing contends that the absence of minimum, rate fixing would lead to disproportionate rebates to large institutional investors. If this occurred, it could saddle the small investor with excessive charges. However, for rate discrimination to be a significant regulatory problem, typically the regulated firms have to have large overhead or other fixed costs, the burden of which may be unfairly shifted to one class of consumers (especially the general public), by charging only incremental rates covering only incremental costs to favored classes. As already noted, such a cost structure is not characteristic of the securities business, and there do not appear to be significant incentives for brokers to provide non-compensatory services for any customers, including investment companies and others engaged in large-volume transactions. Moreover, if rate discrimination were a problem, it would be causing concern now. The present NYSE rate structure does not prevent it, and could not prevent it, so long as alternative channels remain available for the institutional investor, in regional exchanges or in over-the-counter transactions, including the third market in listed securities. In fact, the experience thus far with competitive commission rates does not suggest risk of a discriminatory impact, upon the small investor. So far as the Department is aware, there is no evidence that the effective rates set by negotiation have gone beyond compensating for the present economically discriminatory NYSE rates, or that there is any significant risk of an adverse impact on the rates to the public-at-large.

There may be a possibility, however, that long-term trading relationships, especially of institutional investors, might lead to the granting of discounts, unrelated to cost savings, which are found to be injurious to other institutional investors that may be in competition with the favored ones for the. funds of the public.

If the Commission considers this risk of undue discrimination to present a problem, it may wish to consider some regulatory action aimed specifically to prevent undue discrimination of this type. In any event, the contingency would not warrant continuation of fixed minimum commissions for institutional investors.

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Accordingly, the Department's analysis of NYSE rate fixing in the light of the objectives of the Exchange Act leads to the conclusion that rate fixing is not required or justified except perhaps for the protection of the small investor. The need for maintaining an effective auction market, advanced in support of the present system, does not justify or require minimum commission rates. Furthermore, the objective of protecting investors would lead to the adoption of maximum rates rather than minimum.

There does not appear to be any substantial policy ground for fixing of rates for institutional investors, and on transactions of substantial size. Rate competition for this business is quite feasible and, if freed of the constraints imposed by the minimum rate structure, would appear to have desirable results. The question of the need for maximum rate fixing on transactions of small investors, requires further investigation of the extent to which competition may be relied upon, and the regulatory standard which would be applied by the Commission in reviewing such rates. [Footnote: There is considerable precedent in securities regulation practice for distinguishing between institutional investors and the general public in imposing particular regulation. The institutional investor is deemed to be able to protect himself in a way that the public is not (See, e.g., Louis Loss and Edward M. Cowett, Blue Sky Law (1958), pp. 367-368). Thus, the Securities Act of 1933 (requiring registration of securities) has been treated as not applying to a "private placement" involving a small number of institutions (see Securities Act of 1933 §4, 15 U.S.C. 77d; Loss, Securities Regulation (2nd ed. 1961) 689-696). And the Uniform Securities Act specifically exempts "any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity" (Uniform Securities Act §402(b)(7)). A great many other state "blue sky" laws contain broadly similar provisions.]

III. THE PRESENT NEW YORK STOCK EXCHANGE RATE STRUCTURE HAS THE EFFECT OF UNREASONABLY RESTRICTING ACCESS OF NONMEMBER BROKER-DEALERS TO AN ESSENTIAL MARKET

When an NYSE member broker performs an execution and clearing function for another broker-dealer, the price he charges for the service depends, under the present rate structure, on whether the broker-dealer ordering the service is himself an NYSE member. The differential is substantial. The charge to the non-member broker-dealer is the same as that charged to the general public; and this is almost always several times as high as the charge to another NYSE member. The substantial amount of the differential is illustrated by the following tables of commissions payable for execution and clearing on four hypothetical transactions involving a single round lot (100 shares) in different price categories.

Sales Price Per Share: $10.00
Public Commission: $17.00
Member Commission: $7.30

Sales Price Per Share: $40.00
Public Commission: $39.00
Member Commission: $7.70

Sales Price Per Share: $70.00
Public Commission: $46.00
Member Commission: $7.70

Sales Price Per Share: $100.00
Public Commission: $49.00
Member Commission: $8.70

The effect of this arrangement is clearly to give member firms a very considerable advantage in competing with nonmember broker-dealers. The significance of this restriction is enhanced by the fact that the only firms eligible for membership in the NYSE are those having a partner or director holding one of the exchange's 1,366 "seats".

The NYSE is clearly the dominant stock exchange in the country, accounting consistently for over 80% of the value of securities traded on all exchanges (see Release, p. 4, n. 2). In these circumstances, the NYSE's policies of discriminating in price against nonmembers, combined with restrictions on membership, is open to serious questions under the Securities Exchange Act requirements that every exchange maintain "just and equitable principles of trade" and "fair administration

of the exchange" (Sections 6(b), 19(b), 15 U.S.C. 78f(b), 78s(b)), as well as under the antitrust laws. Obviously, the problem of physical facilities may require some limitation of direct access to the NYSE floor; but the NYSE appears considerably more limited than necessary in membership policies. For example, the London Stock Exchange -- the world's second largest in volume -- has approximately 3,500 members and it further reduces access barriers for nonmembers by permitting commission splitting between members and nonmembers.

It might possibly be contended that the substantial rate discrimination in favor of members is essential to provide an incentive for NYSE membership, and hence to maintenance of the exchange itself. Such an assertion bears a heavy burden of proof, as is clear from a recent Supreme Court decision rejecting the argument by a shipping conference (i.e., a self-regulating group of firms) that restrictions upon competition were justified in order to create "an incentive for members to remain in the conference and for other lines to join". Federal Maritime Commission v. Svenska Amerika Linien, 1968 CCH Trade Cases para, 72,376. The Court held that this "theory" was "insufficient to justify the undeniable injury to interests ordinarily protected by the antitrust laws", in the absence of any regulatory agency, finding that elimination of the restriction would "in fact jeopardize the stability of the conference".

Similarly, in the case of NYSE, there is no evidence that the existence of a substantial differential between the rates charged members and nonmember brokers is necessary to provide an incentive for membership cognizable in the public interest. Member firms will continue to charge for the services actually rendered in transacting business on the floor of the NYSE and in clearing sales; the ability to charge for such services will, of course, be a continuing incentive for NYSE membership. Furthermore, as the Special Study pointed out "[t]he privilege of access, to the floor provides trading advantages of a substantial nature" which is an essential aspect of the value of membership (Special Study, Part A, p. 95). The fact that NYSE is likely to continue to be a natural monopoly as a national auction market for the most important corporate securities will tend to assure substantial membership.

Even if the NYSE membership were to cease to be attractive to those members who do not engage in floor activities, this would not affect the effective functioning of the exchange as an auction market. The NYSE exists, and will continue to exist, because of the demand for a central auction market. From the standpoint of the public interest in the functioning of the exchange, there is no need to artificially promote member ship by individuals or firms who are not interested in participating in floor activities, and to whom membership simply represents a capitalization of the differential between the rates available to members and to nonmembers. [Footnote: It might also be suggested that the

Securities Exchange Act contemplates extensive self-regulation by the NYSE of member firms and that such a system requires a rate structure which encourages widespread membership. We do not believe that the policy of self-regulation can be held to support a commission rate structure not otherwise justified by the Act. In any event, it should surely be possible to encourage NYSE membership and yet avoid the detrimental aspects of the present system. Membership could be open to those who can satisfy objective requirements, who are willing to subject themselves to the standards of conduct provided by the NYSE rules and who pay a fair share of the cost of running the NYSE. This should attract sufficiently wide membership among individuals and firms actively seeking to participate in NYSE floor trading. If it is desired to extend NYSE self-regulation over larger segments of the brokerage community, in order to relieve the Commission of regulatory burdens, this could be accomplished directly by making available associate memberships which do not include the privilege of access to the floor.]

The above discussion emphasizes our belief that restriction of access to NYSE by nonmember broker-dealers is a generally undesirable aspect of the existing NYSE rate structure. This fact is, in effect, acknowledged by the NYSE proposal to offer a discount from the minimum commission to such brokers. The importance of access to the NYSE, moreover, is growing as advances in communications technology and data processing increasingly provide almost instantaneous links of brokers with floor members and with each other, thus enhancing the strength and liquidity of the national auction market which is focused upon the NYSE. Perhaps in the long run, these developments may lead to a national market in which the "floor" brokers and specialists, not necessarily all located at a central point, make a single market through the use of communications and computer facilities. In any event, however the industry develops, access of broker-dealers to the national securities market is a matter requiring regulatory consideration.

The Supreme Court's decision in Silver v. New York Stock Exchange, 373 U.S. 341, is directly relevant to this issue. It held that the NYSE could not deprive the complainant, a nonmember broker-dealer, of the "important business advantages" for the over-the-counter market by denying him access to private wire connections to NYSE members, in the absence of justifications derived from the Securities Exchange Act. This is a special case of a more general antitrust principle which is also relevant to the NYSE market itself: namely, that when a private group has control over access to a market -- and a trading exchange is a classic example of such power -- the Sherman Act requires it to accord access to that market, on an equitable and nondiscriminatory basis, to all those in the trade. [Footnote: This principle has been applied to "require access to railroad terminal facilities through which rail traffic flowed across the Mississippi River, United States v. Terminal R.R. Ass'n, 224 U.S. 383' to an association with monopoly power over newsgathering, Associated Press v. United States, 326

U.S. 1; to a produce-exchange building, Gamco, Inc. v. Providence Fruit and Produce Bldg., 194 F. 2d 484 (C.A. 1), certiorari denied, 344 U.S. 817; to a tobacco market, American Federal of Tobacco Growers v. Neal, 183 F. 2d 869 (C.A. 4); to a fish market, United States v. New England Fish Exchange, 258 Fed. 732 (D. Mass.); and to a livestock market, cf. Anderson v. United States, 171 U.S. 604, 618-619.] As noted, physical access to the NYSE floor has to be limited, but the monopoly characteristic of the dominant exchange gives rise to the duty of fair and non-discriminatory treatment of others; and it does not of itself justify different treatment of members and non-members for the same service.

Fair access of nonmember brokers to trading on the NYSE could be achieved by a variety of modifications in the present structure. Alternatives are (i) to require equal charges to members and other brokers insofar as the same services are rendered; (ii) to authorize sharing of commissions with nonmember brokers; (iii) to make NYSE membership available on the basis of objective standards; and (iv) to provide a differential prescribed by the Commission. The Department is not prepared at this time to make a choice among these alternatives, and it suggests that this problem should be considered in a further proceeding.

IV. THE COMMISSION AND NYSE PROPOSALS TO MODIFY THE NYSE RATE STRUCTURE WOULD BE LESS EFFECTIVE THAN THE ELIMINATION OF RATE FIXING ON INSTITUTIONAL TRADING

A. The Commission's Proposed Rule

Proposed Rule 10b-10, as the Commission notes, is "an approach to the give-up problem which would not require significant change in the existing commission rate structure." It is acknowledged by the Commission that this would be a "substitute for full re-examination of the structure and rates of commissions on the national securities exchanges." But for the reasons stated in Point II above, it is that fundamental reappraisal that is required.

In essence, the rule would require that give-ups inure to the benefit of the customer directing it, where the customer is a registered investment company. this would be accomplished by prohibiting an investment company from directing give-ups unless it is assured by contract that the amounts would be paid over to it, or that the fees charged it would be reduced by the amount of the give-up.

The Department agrees that the proposed rule would alleviate the fiduciary problem of diversion of give-ups by fund managers. We recognize that it also seeks to prevent distribution to others for services not connected with the particular transaction. We submit, however, that the proposal would not deal with other problems inherent in the present system, and that it is no substitute for a

revision which would enable institutional investors to negotiate directly for reduced commissions.

The proposed rule, which doss not seek to affect the present rate structure, in fact, seeks to do by indirection what elimination of rate fixing would do directly. Instead of being able to pay the low commission arrived at by competitive bargaining, the investment company would have to pay the full NYSE rate and to direct payment of the excess amount through another member or broker, whence it would return to the company. This is mechanically cumbersome. It involves unwarranted costs. Moreover, it leaves room for continued misallocation of trading and other services. The fund manager is not prevented from using commissions to compensate for services such as sales of fund shares; he could do this by foregoing a portion of the give-up (when the transaction is executed by a favored broker). In addition, the rule, by providing that the fund could be recompensed by reduction in fees, anticipates that give-ups would be channeled to firms providing other services unrelated to the particular transaction, which may tend to distort competition for services and to induce the performance of unneeded investment services. Finally, the rule is limited to investment companies, which retains a distinction -- not shown to be warranted -- in the effective rates available to mutual funds, and those available to other institutional investors and to persons trading in large blocks.

Moreover, assuming no changes in the NYSE constitution and rules are intended, the return of commissions would have to be channeled through the classes permitted to receive give-ups by the NYSE rules, i.e., only NYSE members. Further restrictions could be adopted by the NYSE. The Commission's statement that the mutual fund manager is obliged to use the "means at his disposal to recapture [commissions] for the benefit of the fund" (Release, p. 8) thus leaves open the possibility that the NYSE could limit the means and amounts available for "recapture".

Many of the problems attendant to the give-up would disappear if a rule were adopted eliminating rate fixing by the NYSE on these transactions, since it would eliminate much of the present impetus for discounts in the form of give-ups. In such a context, the proposed Rule 10b-10, dealing with the fiduciary duties of a fund manager, and serving as a supplementary rather than as a sole solution, has a better prospect of success. The investment company would already be able to obtain directly the same negotiated commission rate proposed to be obtainable indirectly under the Commission's rule. This promises to be the most efficient and least costly method of solving the problem of give-ups and reciprocity. It would encourage, if not require, the fund manager to separate trading decisions from the arrangements for other services, and thus lead to judgments in both areas which should inure to the benefit of the fund. In addition,

in revising the NYSE rules, the Commission could assure the availability of competitive rates to investors other than mutual funds.

Little comment need be added about the NYSE's objections to the Commission proposal, recently filed in this proceeding. Aside from an unsound defense of give-ups and reciprocal dealing as desirable practices (which we have dealt with earlier), the NYSE essentially argues that (a) the Commission is seeking to require negotiated commissions, instead of the fixed commissions which are essential to the exchange market; (b) the Commission is seeking to impose upon institutional managers the fiduciary obligation to seek the highest give-up, which would hamper their ability to achieve the best investment performance. The short answer is that (a) commissions are now already being negotiated, and the fund should be able to obtain the benefits of such negotiation directly; (b) institutional managers already have the fiduciary obligation to achieve the best and most economical execution of transactions, and the further fiduciary responsibility to obtain the other needed services on advantageous terms would be enhanced by requiring them to be procured separately.

B. The NYSE Proposals

(1) The first proposal is for a volume discount for large blocks of stock. The NYSE offers the principle only, the details and level of the discount are to be filled in later. This in effect recognizes that charges for brokerage services should be more flexible and, particularly, that such charges should to some extent reflect the costs of the services. As such, it is meritorious. And to the extent a volume discount reflects the savings which should accrue to institutional investors or others trading in large blocks, it will eliminate the incentives for give-ups and reciprocal arrangements. Whether the NYSE proposal would be so effective will depend upon the levels which would be fixed. [Footnote: If a volume discount is to be adopted, the further NYSE suggestion of a cumulative volume discount may raise competitive problems. A single large-block transaction involves considerable savings in execution and clearing. It is not apparent that a series of orders aggregating the same amount would involve equal savings. If not representing cost efficiencies, a cumulative volume discount system could be a means of providing unwarranted reductions to large-volume traders in exchange for their assurance of continued patronage. It would operate in effect as a requirements contract for brokerage services. Other agencies have found payment plans which had similar effects to be unlawful. See, e.g., the ICC's decision on a railroad tariff in Contract Rates on Rugs and Carpeting, 313 I.C.C. 247, 194 F. Supp. 947 (S. D. N. Y.), affirmed, 368 U.S. 349; the FCC's decision on a network's "incentive compensation plan" in Application of Section 3.568(a) and (e) of the Commission's Rules, FCC 63-500 (released June 4, 1963).]

We believe, however, that a volume discount schedule is not as effective and flexible a solution as the elimination of rate fixing on these transactions. Any prescribed discount schedule will, at best, be an average of the savings anticipated, from large-block transactions. Although the precise amount of actual savings in each case would depend upon the services required and other circumstances, the rate schedule would apply across the board to all parties engaged in transactions of a certain volume. In some cases, the prescribed discount would be larger than that which would be negotiated. On the other hand, in cases where the volume discount is less than the savings available, the investor would press for a return or give-up of an additional portion, thus continuing these practices and their problems. Moreover, the schedule might require continuing revision to keep it current with shifting costs.

This situation might be unavoidable if there were evidence that competitive negotiations were not an available alternative. The fact is, however, that the bargaining process now in use has been arriving at discounted commissions which appear to be satisfactory to the investors and the brokers, and suited to the particular case. It would appear to be simpler to make those discounts available to the investor, rather than to seek a prescribed rate.

(ii) The NYSE proposes to continue customer directed give-ups with a limitation on the amount to be given up. This proposal is significant to the extent that it indicates that the NYSE does not intend to prescribe a volume discount at a level which would approximate the cost savings, so that the investor could receive the benefit of reasonable rates directly. The proposed continuation of give-ups would carry with it all the complexities, the distortions in the securities market, and the fiduciary hazards discussed earlier and described in the Commission's release. The objective at this time should be to eliminate the adverse, effects of these practices by permitting the salutary competitive pressures to have their normal outlet, in negotiation for competitive commission rates.

We oppose any limitation on the amounts of the give-ups. So long as a prescribed minimum rate structure exists, which may sooner or later prove to be, in fact, unrealistic, the obtaining of give-ups and other arrangements provide the only means by which at least some investors can obtain the services of NYSE member firms at a reasonable price. Give-ups will probably disappear when there is no need for them -- when rates themselves can be the subject of competitive bargaining.

(iii) The NYSE also proposes that reciprocal practices be prohibited altogether, since they result in de facto rebates of NYSE commissions to nonmember brokers; and that the Commission should prohibit such practices in the regional markets. This appears to be merely a reaction to money escaping from the NYSE community. Except for the fact that the excessive commissions are available for

distribution to a wider group, the reciprocal practices have the same effect as give-ups. The regional markets' willingness to have commissions shared with nonmembers ameliorates some discriminatory features of these practices and has even permitted some funds to recapture portions of the excessive fees. All these devices represent an unnatural and distorted form of competition, and since they give rise to serious problems, the optimum solution, again, is to enable the investor to obtain for himself directly the benefits pf an effective reduced commission rate.

Again, however, so long as an unrealistic rate structure continues, reciprocal practices -- like give-ups -- constitute "the only available means by which investors may obtain reasonable commission rates. We therefore oppose the NYSE proposal to prohibit them, or to limit the freedom of regional markets to broaden the permitted recipients. Just as there should be no limitation upon the amount of excessive commission obtainable by the investor, so there should be no limitation upon the persons to whom those commissions can be distributed.

(iv) The NYSE proposes a discount in the minimum commission schedule for nonmember brokers. As we have discussed in III, revision of the NYSE structure to allow access to the market on reasonable terms to nonmember brokers appears to be imperative. The NYSE proposal is one device which could achieve this result. We have earlier indicated alternative approaches. The choice among these alternatives should be a subject for a further Commission proceeding.

V. THE IMPACT ON THE REGIONAL STOCK EXCHANGES AND THE THIRD MARKET OF ELIMINATING NEW YORK STOCK EXCHANGE RATE FIXING DOES NOT PUT IN QUESTION THE DESIRABILITY OF SUCH ACTION; IT DOES SUGGEST FURTHER COMMISSION ACTION ON NONMEMBER ACCESS TO THE NEW YORK STOCK EXCHANGE

The Commission release raises as an issue the effect of proposed changes in the NYSE commission rate structure upon the other markets in which NYSE listed securities are traded -- (a) the "regional exchanges" and (b) the so-called "third market" among over-the-counter dealers. There are public interest considerations in the latter markets' competition with the NYSE; the Commission thus once struck down an NYSE rule which would have unfairly injured regional exchanges. In re Rules of New York Stock Exchange, 10 S.E.C. 270, 283-284, 287-288. In the present context, it is significant that these other markets have provided important alternatives to, and competitive pressures upon, the unrealistic NYSE commission rate structure. In this proceeding, the Commission should reject any proposal to restrict the freedom of these markets; an example

is the NYSE proposal to prohibit the regional exchanges from permitting more liberal reciprocal arrangements than the NYSE, discussed in III, above.

We recognize that the viability of these markets may be affected by substantial rationalization of NYSE practices and price structure, to the extent that they depend upon the ability to offer a lower commission or more flexible rules relating to commission-splitting on transactions involving NYSE listed securities. As we discuss below, this may be serious for the regional exchanges, but is not likely to impair the "third market". These consequences, in any event, would not support retention of an unrealistic and inequitable rate structure on the NYSE or militate against the steps we have proposed. The raison d'etre for the regional exchanges and the "third market" -- like for the NYSE itself -- is their economic usefulness, and the public advantages of their operations. Artificial props to support them are not justified. There are actions, however, which may be taken to enhance the operation of these markets, in areas where they fulfill a function in the public interest, And there is also support for our recommendation that the terms on which nonmember brokers can obtain access to the NYSE should be modified.

A. Regional Exchanges

Trading on the regional exchanges accounts for more than 10% of the value of securities traded on exchanges, as opposed to approximately 80% for NYSE and slightly less than 10% for the American Stock Exchange. However, "substantially all of the regional exchange volumes consists of trading securities also traded on the New York Stock Exchange" (Release, p. 4 n. 2). The figure in 1962 was 93% of regional exchange volume (Special Study, Part 2, p. 949), and it is probably higher today. Thus, the regional exchanges, which "were originally conceived of as primarily private local markets for local securities", have become largely secondary local markets for securities traded on the New York Stock Exchange. (Release, p. 7; see Special Study, Part 2, pp. 911-952).

In the latter function, the regional exchanges are largely not performing as auction markets. Rather, they are being used as a way of transferring brokerage payments from members of the New York Stock Exchange to nonmembers. They have thus provided a location for the recording of privately negotiated "cross" transactions in NYSE listed stocks and the distribution of give-ups, and for reciprocal transactions in which a NYSE member splits commission with a regional exchange member, in the return for other business. As we have said, these practices have brought various unsatisfactory results, but they have constituted the only available way to achieve reasonable and competitive rates. In short, the underlying reality is that the regional exchanges in this respect have been acting as "a kind of relief value for pressures resulting from the inflexibility of the public commission schedule of the NYSE" (Special Study, Part 2, p. 927).

This being so, it seems likely that providing competitive commission rates on the NYSE may well cause the regional market's business in NYSE listed stocks to flow back to the NYSE itself. It seems apparent that the regional exchanges lack the depth and liquidity to sustain separate markets in NYSE listed securities. And the great increases in communications techniques in recent years has further undercut the usefulness of having public local markets in such securities. The significant policy question is whether the loss of the "trading", in NYSE listed stock would so weaken some of the regional exchanges as to cause them to fail; and whether this would be a substantial detriment because it would reduce the availability of "relief valves" for NYSE trading in the future, and because it would weaken the market for regional securities.

The long-term significance of the regional markets, we believe, will probably depend on their ability to provide primary markets for regional securities. (See Special Study, Part 2, pp. 951-952.) Their role in this regard has declined, as the trading in regional securities (e.g., bank stocks) switched to the over-the-counter market, which has benefited from improved communications, and which, in some respects, may be better equipped to handle transactions in securities having a relatively "thin" market. In addition, some local or regional companies have become sufficiently large to turn to the national markets of the NYSE or the American Stock Exchange.

What impact does the potential role of the regional markets have upon the issues in the present proceeding? We submit that recourse to otherwise desirable steps should not be affected by this consideration. The past importance of the regional exchanges as a "relief valve" emphasizes the need to remedy the situation which required relief; there can be no basis whatever, to perpetuate that unsatisfactory situation in order to give a purpose to the regional exchanges. Those exchanges should continue, rather, if they have a natural economic function to perform. If the Commission should in fact decide that preservation of some or all of the regional markets deserves special support, it could seek by regulatory actions or legislation to make the regional exchanges more desirable as markets for local securities, and to promote their use. [Footnote: The enactment of the Securities Act Amendments of 1966, substantially extending the Commission's jurisdiction of over-the-counter securities, should minimize facts or the difference in applicable regulation, which may have tended to favor the over-the-counter markets over the regional exchanges.] If that business would yield insufficient financial support, direct subsidy could be provided. Finally, any resulting uncertainty as to the future of regional exchanges would further support the need for a modification of the terms of access to the NYSE market for nonmember brokers, such as those now in the regional markets.

B. <u>The Third Market</u>

The so-called "third market" is an over-the-counter market for securities listed on an exchange, principally the NYSE. The participants in the market are over-the-counter dealers and institutions dealing directly with them; NYSE member firms are prevented by exchange rules from dealing off the floor in listed securities. The Special Study (Part 2, p. 873) found that the third market in 1962 accounted for about 4% of the "value of transactions in NYSE listed securities. The third market transactions tend to be in the most widely traded stocks on the NYSE board, such as AT&T. And the transactions tend to involve large-block trades, as for institutional investors, or trades in small numbers of shares where the third market is being used as an alternative for the NYSE odd-lot jobbers (Special Study, Part 2, pp. 873, 878-879).

The third market has grown up in response to the minimum commission rate structure of the NYSE, particularly the absence of a discount for large-volume orders. The "off-board market maker" has made inroads by his ability to quote prices to institutional investors of commissions that were better than the combination of exchange price and commission (Special Study, Part 2, p. 907).

As with the regional exchanges, this basis for third market operations may well be undermined by any rationalization of the NYSE commission rate structure which would provide competitive rates. There would appear to be no particular advantage in taking trades in listed securities anywhere other than the NYSE floor if the costs were comparable, and all other things were equal. This does not, however, raise serious concern about the viability of the third market firms. They will continue to have over-the-counter operations in unlisted securities. Moreover, even in listed securities, past experience shows that the third market is competitive with the NYSE in handling larger blocks of securities, as for institutional investors. Transactions of this type require a process of negotiation, for which they are quite suited, as distinguished from a continuous auction market which is subject to disruption from a large single transaction. The third market firm may be able better to gauge the depth of the market for a large-block transaction, and possess capability of taking larger positions (Special Study, Part 2, p. 907). Finally, if the terms of access to the NYSE market were liberalized, the firms participating in the third market would be able to play an active and useful role in NYSE trading.

As with the regional markets, the situation of the third market does not raise any doubt about the desirability of our recommendations to revise the NYSE commission rate structure. The third market may be entitled to protection against unfairly restrictive NYSE rules. But basically it should stand or fall on its own strengths or weaknesses. To the extent that it can withstand a reform of NYSE commission rate practices, to that extent its continuation is warranted and to that extent it will continue to serve a function.

Respectfully submitted.

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