carrot out there to entice firms such as Morgan Stanley and ourselves to commit capital or to pay the extra eighth, that carrot is not out there as much, and I think the measure of that is the number of firms that have backed away from a commitment to this business.

COMMISSIONER GRUNDFEST: If I could pursue that, because there are a couple of mysteries over here that just do not really fit.

Let's take the example of the 100 or the 150 most liquid securities.

Apparently the price, or the liquidity in the market for those is such that there is still enough room in terms of the amount of money you can make executing those that you still have enough left over that you can afford to pay for the soft dollar services.

In other words, if the pricing really were as tight as possible for somebody who is just doing execution, there would not be anything left with which to pay for the soft dollar research and everything else that goes along. This is derivative of a question that the Chairman asked earlier on. So apparently, the fact that by trading in these 150 or 100 most-liquid stocks still generates enough excess revenue so that the soft dollar provider can bear the costs associated with the provision of the soft dollar services suggests that even the most liquid of stocks are not as liquid as they could be.

Might this in some sense be related -- let's take the absolute tightest markets -- to the fact the smallest tick is an eighth, and that the real spread could be less than an eighth if you moved the decimal prices?

Are there other factors that are at work?

MR. SILFEN: To answer Commissioner Grundfest's question, I think that many trading desks have found it very easy to quantify their market execution expense if they are dealing with it in the Sears and the GEs of the world where there is a 50- or 100,000-share market on the floor of the New York Stock Exchange, and they know the worst-case phenomenon is they are going to sell it on the bid or buy it on the offer.

We have at periodic times in the past in a general sense offered major institutional clients around the country the opportunity to stop them on the bid and the offer in these 100 or 150 stocks, which means that is the worst-case phenomenon.

That has not met with too much success, because I thank that if that type of order flow got directed away from many soft dollar firms that I believe receive that, that do not have capital commitment and distribution capability, it would be much more difficult to pay them.

I think the desirability out there for the firms that have these obligations is that they can very easily quantify the market impact by dealing in these 100 or 150 stocks with the soft dollar firms.

MR. KETCHUM: Mr. Beard?

MR. BEARD: Commission Grundfest, I would answer your question this way; I think it is a good one, that essentially the execution business has been unbundled, that the major trading firms do not see those orders and those more liquid stocks, and they have been relegated over.

I would go back to the point that you made earlier about why not unbundle -- you did not phrase it that way -- research services completely, which means paying for all of them in cash?

I think that our firm would be a strong -- and maybe we are singular in that -- would be a strong advocate of the best way to get an underground economy above ground is to put the light on it and do away with the commission, which is the only thing that people can really measure the best execution, and provide a commissionless environment for institutions to trade in that are relegated strictly to price and pay for research services as they are currently paying for execution services with hard dollars.

MR. KETCHUM: One of the steps to unbundling that has been discussed recently, and I think particularly by your firm, Mr. Beard, is the possibility that rather than depending on commission dollars with respect to off-positioning activities, that firms might shift to simply making net markets and not charge a commission rate, but instead try to gain whatever profit can be made out of a trade entirely by the quote from the spread that might be made in that traded position.

Is that the part of unbundling that you see happening in coming months or years?

MR. BEARD: We would be a strong advocate of a change in rule 10(b)(10) that would permit institutional participants from orders over a certain volume size, either measured in shares or dollars, to be able to execute through brokers on a net basis and still report the transaction in the context of the current market and the current exchange mechanisms.

The thing that we are most concerned about, if that were to be accomplished and people were still allowed to buy order flow with a certain rebate or to soft dollar order flow, you really gain nothing.

So it is our view that you have to clean up both aspects of the transaction simultaneously.

MS. MCGRATH: Could I question Mr. Silfen?

In responding to Commissioner Grundfest's question, I did not understand your answer clearly.

Were you saying that there has been occasions in these top 100, 150 stocks when you have offered or would have provided a better overall price, but the institution took the business to a soft dollar broker?

MR. SILFEN: We believe that there have been a number of instances where we have, on a general basis, gone out to the institutional community and said that we would offer to stop people at prices.

Clearly when you see transactions take place at that price or higher, there is somebody out there in the universe -- you do not know who it is -- that has deemed for whatever reason that they would prefer to do business with other firms. I think that is a phenomenon that exists on a fairly regular basis.

COMMISSIONER GRUNDFEST: To go back to a previous analogy that I use, it is like somebody taking a flight that is more expensive because they want the frequent flier miles, not because it is the cheapest flight for the employer.

MR. KETCHUM: How much, if any, of this is relevant, really is related to soft dollars?

How much of it is really just related to continuing pressure on commission rates in the industry today and would exist were there no soft dollar business at all?

MR. SILFEN: I would say that for openers you have got something that looks like 20 percent of it that could be redirected to firms that are in a position to offer value added. Beyond that, then you get a question as to whether or not people can raise commissions.

I think it has been very difficult for institutional firms to get a higher rate on even value-added business when in the two-tier pricing mechanism they feel the pressure of the commodity rate out there, and the value-added trade is always to a degree being compared to the commoditized rate. On top of that, feeling the pressure from the consultants and the plan sponsors where they receive questions, "Why did you pay 10 or 12 cents on this transaction?"

It seems so out of line with what is offered in the commoditized part of the world in which the soft dollar business is clearly a major part of it.

MR. KETCHUM: From the money manager's standpoint or the pension plan sponsor standpoint, are these developments a matter of concern to you, or do they just merely reflect a rational response of firms to start properly pricing or separately dealing with block positioning from the other business and not resulting in any significant changes to the way you conduct your business?

Now, to some point, you are in sort of the privileged category of those firms in which the major firms do not seem to suggest they are going to change their practices, but are changes in block positioning practices a possible move to that market and like something that is of a concern to you or not?

Do you see changes in liquidity in the market?

MR. GEORGE: I will try; it is hard to get your arms around this and sound like I make sense.

First of all, going back to, I guess it would be the early '70s and late '60s, we developed something what I call the "liquidity machine," which is a really pretty awesome vehicle.

I have lived though in my lifetime at least four times, I think, when I have spoken up and said, "My God, the brokerage committee is going to fall apart," and it has always come back stronger than ever.

I am, I think, a good reactor; I am not a good look-forward person. I have a feeling, though, we might be in one of those times when what I lose will be something that will not be put back together easily.

It is a complex relationship.

The rate is a key ingredient, and rates have reached levels I did not appreciate possible, and yet as Commissioner Grundfest has suggested, there still seems to be ample money for some people, so I am finding that the cost of execution, at least for some people, is much less than I ever imagined is the case.

I do believe that ability to transact larger than market size and/or to transact quickly when the contra side is not available is an option that as a money manager we would not want to use. We do not avail ourselves of it all the time.

I suggest in the sliding downhill theory, T. Rowe Price, I think, is competent enough that we would be able to hold our head against the competition, but I never liked the idea that we all do a little worse, but we are better than what somebody else is.

CHAIRMAN RUDER: Did you say you did not "use" or not want to "lose"?

MR. GEORGE: "Lose." I do not want to lose this liquidity machine that has been developed.

CHAIRMAN RUDER: If I look at it from the point of view of a regulator that is worried about market volatility and market liquidity, if what we are seeing is the possibility of losing market liquidity because those people who are engaged in the block positioning business are moving away from that market, then we are faced at least with a potentially great problem if we should get into an October 19, 1987, situation in which there is a demand for this enormous liquidity.

Is that what you are concerned about?

MR. GEORGE: Yes. I would suggest that the business decisions that many people have made, I think recently, in not being as competitive in a positioning sense are intelligent. In other words, why give away money in this kind of environment?

I do also suggest that any reallocation of resources clearly has started. The institutional equity gang has not been a money maker. I do believe the statements of these gentlemen.

We start to see analysts that we have thought very highly of not as available to us anymore as much as they were, because they are not better serving themselves and their firms in the investment banking side.

We see a steady shift of resources to M&A and Arbitrage in a way where at least I sense; I do not have the numbers to say it.

So I do think that the environment is such that these people are making intelligent business decisions, which makes my job harder to do.

MR. KETCHUM: If that is true, if block positioning services are valuable to you, why are you not willing to pay more for them?

Why is the market not properly pricing the value of those block positioning services?

MR. GEORGE: I do not want to cause my desk an undue number of phone calls. I guess I would suggest that that is something that the brokerage side has to wrestle with. I think it is theirs to ask and mine to give rather than the other way around.

MR. KETCHUM: Are there other views from the money managing side of the table?

MS. STARK: I would heartedly agree with Austin. It is a service that the brokers have up until now provided, positioning, that is, their capital commitment provided at the same rates as regular old-agency business.

If you do not have to pay more for something, why bother?

However, if they decide -- and I think this is starting, because I have received calls from several brokerage firms in the last couple of weeks, saying that if you are going to ask us to use our capital, we are going to ask you to pay us at least "X" cents per share to use it.

I really do not have a problem with that -- at least I hope I do not get a lot of calls either -- but it is a service.

But at the same time, I am not going to pay more for something that I never have before, unless they come and ask me.

COMMISSIONER GRUNDFEST: You are not shy.

MS. STARK: No.

COMMISSIONER GRUNDFEST: Understanding that what is good for the goose is good for the gander, if these prices are going to reequilabrate in such a way that you remove what some people would call a cooling equilibrium, and you move to a situation where you are going to have pay more for firms that are willing to put their capital at risk in more difficult trades or larger trades, what is going to happen is you may also find forces pushing people to the point where you are going to pay less for the raw execution of easier trades, and some of the people that are working in the soft dollars environment may, down the long run, find, hey, wait a minute, people are not willing to pay us so many cents per share when they can go into a different environment, unless there really is a monitoring problem going on over here because of a lack of information from the plan sponsors, which may really be the case, and because some fund managers may have moved to an environment of perhaps over reliance on soft dollar provided services and are perhaps at the margin, paying more than what is worth to them, which is what would happen if you have got a monitoring problem.

MR. KETCHUM: Mr. DaPuzzo?

MR. DAPUZZO: Along those lines, a major firm had a conference last year where they had about three-quarters of the attendees from major institutions and the other one-quarter was from the broker-dealer side, and then some people was -- the industry and is not making money. It was sponsored by Paine Webber.

The discussions there were more on the rates and how much lower they had become, and the fact that there was lower volume, and the fact that we were having higher real expenses in addition to position loses, and basically the rates were the key culprit, and I was sort of focusing on soft dollars more.

But as I recall, the function for block trading, a key point that Holly said before, if they call, if an institution calls and asks for positioning, I think it is a different ball game that many institutional type houses go out on an Autex machine as well as buyers, and they are basically not a natural buyer, but they are willing to put up their money because of trend or because they want to get into the game, and they want to get that order flow.

Quite a few years ago as that positioning was developing, certainly it was done officially to many institutions, but at the same time it was detrimental to many other full-service firms, because the firms who were doing positioning had a certain amount of money allocated to them, and it was their way of capturing market share.

So basically we could have the very same type of conference saying, is this a fair thing that this positioning is being allowed to divert business away from the natural buyers who might be being outsized by the broker's capital, where natural buyers are out there as a buyer of 20- or 30- or 40,000 are not getting that call because the broker is out there as a buyer of 100- or 200,000 putting up his own money.

MR. KETCHUM: I guess that representatives from Autranet and CIS have been extremely polite in holding back for the last 20 minutes in this discussion.

You have both submitted articulate positions suggesting both the benefits in competition and services provided that your firms provide as well as your strong view that block positioning is just another service and should be viewed that way.

I do not know if you would like to give some reaction to the discussion and the concerns that have been raised by the firms.

MR. POTTS: Liquidity, I guess, first of all, liquidity abounds.

This market serves the largest pool of capital that has ever existed in the history of the earth. I think that research is superfluous to a conversation about liquidity. The fact is that the Congress deregulated and prices came down. Prices came down about 80 percent. Volume went up 900 percent. The tickets were still official.

But to remove research from the equation does not follow that prices then would rise and remove the problem that we are citing right here.

What we are bringing to the marketplace here is competition, and competition creates lower prices, and lower prices will create volume, as I just outlined, and volume is liquidity.

Liquidity, however, is provided by the buy side and not by the broker-dealers, and that is where it should be. There is the natural market to the extent that brokers provide a bridge in terms of liquidity, they should be paid for that.

MR. CUSIC: I think we look at this whole issue as part of the process that started back in 1975 when the fixed-commission structure was legislated away, and we began to have discussions at that period time. Some of the same firms who are now raising the issue of liquidity were raising the same issue back then with respect to negotiated rates.

In effect, I do not think, Autranet does not think, and I think that particularly the buy side, which is where these decisions are made, does not seem to think that soft dollars, per se, is to blame for a lack of liquidity. There are many, many complex factors involved there, program trading being one of them, scaring the small investor away from the market. That removes liquidity. That is something that, of course, you have all heard about.

We look at the research component as being the major reason why we are able to differentiate ourselves. What we have done is unbundled research.

The institutions have a choice as to what they want to use their commission to pay for.

A number of the full-service firms in the excesses of 1986 and '87 have found their costs to be way beyond their control. So the natural reaction at this point is, when you have an oversupply of a lot of things, try to find the area that is providing efficiency and try to make that look as though it is causing the problem.

We think it is a much larger problem. The industry is undergoing a restructuring. We think this is what the Congress and the SEC desired with respect to all of the information that has come out, the interpretive memorandum, and so on.

As Don points out, this is competition.

So we feel very strongly that this is a positive environment. We think it is beneficial to the investor. We think the money managers are recognizing that they are making choices now with respect to how their commissions are used, and we hope you all agree with that.

MR. KETCHUM: Liquidity, indeed, is a very difficult thing to measure.

Mr. Binns, I know you, in your statement earlier, expressed some concerns about the present levels of liquidity in the market. Do you see worries or concerns with shifts in block positioning activity of the major firms, or do you think that, at least with respect to your plan, they do not pose any direct threat?

MR. BINNS: I am not sure that I am prepared to answer that question.

I think that we do see some from talking principally to our investment managers that we get the idea that there has been some dropoff in liquidity, and we have to some extent experienced that with a portion of the equities that we manage internally.

This causes us concern, as I said in my written statement. We do not think this is entirely attributable to the reaction to the '86 changes, the liberalization of 28(e), but that is possible that that is one factor. We think that is probably true.

MR. KETCHUM: To underline a point Commissioner Grundfest made before, certainly an important part of the entire question relating to soft dollars is the ability of money managers and pension plan sponsors to monitor the quality of executions that are being provided in the marketplace with respect to pension plan sponsors to be able to monitor generally what their money managers are doing.

From the pension plan sponsor's standpoint, I would appreciate your view, to follow up a little bit on the discussion before, as to whether you find the disclosure in this area to be adequate and whether you receive disclosure from the money managers that provide you sufficient details of what they are engaged in with respect to soft dollar business.

MR. BINNS: Are you asking me that question?

MR. KETCHUM: No, that was extended to any of the people from the pension plan side.

MR. SCHWAN: I think I responded to that in an earlier response that we do monitor on a monthly basis what our external managers do in the way of what they pay in the way of commissions, who they pay it to, how much soft dollar credits are accumulated, how much they pay commissions on a pay-share basis.

We monitor that with all the external managers as well as our internal trading desk.

We have, naturally, actually an internal policy of what we will pay in the way of per-share commissions.

We do not control the managers in that, they pay what they need to in order to get best execution, because they are also paid by us, on a net basis, performance fees.

So we think that gives them some incentive to look for best execution, including the lower commission costs.

MR. KETCHUM: From the money managing standpoint, what is the detail in which you generally disclose your commission dollar practices to your clients?

As Mr. Schwan described, with respect to his comment, do you provide that level of information generally to your clients?

MR. GEORGE: That is not really my end of the business, so I cannot really definitively answer what we do provide. My suspicion is that it is not considerably beyond what the ADV provides, which is fairly detailed but general.

On the other hand, we have had some clients come in and want to sit on our trading desk and see, literally, what we do and how we do it. We welcome that, but I do not think it is very extensive, but I am not the one that can disclose it.

MR. KETCHUM: One last question, and that relates to the Commission's interpretative standards set out in 1986 and any confusion with respect to them.

While the Commission standard is fairly direct, it did underline that there may be many services, both hardware and software services, that are designed in a manner in which benefits from those services run both to the money managers accounts as well to some degree to direct activities of the money manager which are not directly attributable to the benefit of those accounts, whether it be for administrative purposes or otherwise, and that in those situations, the money manager is responsible for allocating between that percentage of the service, which reasonably can be identified as providing the benefit to the accounts, and that percentage of the service which only runs to the benefit of the money manager.

Has that interpretation raised problems and how do you go about that type of allocation procedure?

MR. RIES: I think we found, first of all, the interpretive release to be very helpful. As I said, it answers many of these questions that before were very technical issues that had to addressed on each and every research project. I think that from that standpoint it has been a very useful thing for all of us.

What was the other question you had?

MR. KETCHUM: Do you have procedures generally in place as to how you allocate services that may be both of benefit to you from an administrative standpoint and a benefit to your accounts?

MR. RIES: We have procedures in place, but generally we have not received services where the allocation has really been necessary.

I had one situation involving service one of the managers wanted to receive. In addition to the software and the actual data they received, they got an IBM PC, and the question was at that time, "Can we receive the IBM PC at all?" After the '86 release, I guess they can.

So that is the only case we have had to do allocation, and I think that has worked fairly well.

When one piece of data is running that is clearly research, then that is allocated to soft dollars. The other portion -- it is done on time, in other words -- the other portion would be allocated to hard dollars.

MR. KETCHUM: A second or related question involves the question of what you do with respect to pension plan sponsored directed business. In that case, that business, of course, is outside the Section 28(e) safe harbor since the pension plan sponsor does not execute investment discretion with respect to that order.

Does the protections, with respect to aggregating orders or to employing orders of accounts which may not benefit from the particular research or service is not there, how has the practice of all this pension plan sponsor business become more significant with respect to how you handle those orders, with respect to other orders in the same security?

Generally a money manager will aggregate orders of a number of accounts. What do you do in the context of a pension plan sponsor directed business?

MS. STARK: That is one of the difficulties, actually, since you typically as a money manager handle accounts for more than one client, and you want to aggregate orders and receive the benefit of a block transaction and hopefully a lower commission.

If a plan sponsor asks you to direct some of their commissions, you then have to segregate that order. If you have several accounts who ask you to direct commissions to several different brokers, that might, instead of doing one nice, neat transaction at one price with one broker, you might then have to segregate those trades out and go to ten different brokers to get that trade done.

It also involves very copious record keeping, because obviously the rules state that you cannot use another account's commission dollars to purchase a service that benefits only that one account.

MR. KETCHUM: Are there other interpretative questions with respect to the section generally that anyone believes raises compliance difficulties or problems with respect to the operation of how the business offer it --

COMMISSIONER GRUNDFEST: Rick, if I could back up and just ask one last question, try to put together two observations.

The observation was made with regard to the information provided to the fund sponsors and the trustees about soft dollars.

The ADV requirement really is rather general, and from just looking at the ADV requirement, a trustee would not know, for example, exactly how much was being paid annually in soft dollars, or what those soft dollars were really paid for.

I take it that you guys do not volunteer to provide that information, and the trustees would actually have to write you a letter and say, "Please, itemize for us exactly with whom you have soft dollar arrangements what it is you get, and some sort of valuation of that. How much do you pay for it?"

What kind of arrangements do you have with the Board of Directors?

MR. GEORGE: Since it was my comments that provoked the questions, I feel like I should try to answer it.

First of all, I am in two worlds. We are a mutual fund firm as well as a private client firm.

On the mutual fund side, the disclosure is a copious, extensive in detail.

On the clients side, again, I am not the one to provide it, so I do not know to what extent our people have given specific information. I know I am not privy to detailed disclosure, and I would suggest that in many cases the clients have not demanded it of us.

This business is complicated enough that we are not trying to withhold a thing. On the other hand, you do not want to burden people with a tremendous amount of detail which is going to have then be unravelled.

COMMISSIONER GRUNDFEST: I have a suspicion that many of the actual claim trustees and sponsors are not asking for this information, and therefore do not even know what is going on.

MR. GEORGE: I would suggest that we would be very unlikely to withhold it if that was requested.

COMMISSIONER GRUNDFEST: I would agree. I think they would have to make the request first.

The question then comes down to, assuming that you gentlemen make the requests and you get the information, what will you then do with it?

Suppose you find a situation where you are paying two managers exactly the same amount of money. They are running the same size portfolio and one of them tends to use a lot of soft dollar arrangements, whereas the other does not.

Would you try to negotiate down the fees that you pay to the person who is using the soft dollar arrangements or not?

MR. BINNS: That is an interesting suggestion as to how to deal with this.

We have not done that thus far, but it may be a way around the concern that we have about the investment manager using soft dollars to pay for things that we think ought to be covered and the fee that we pay to the investment manager.

Frankly, we need to develop a better system than we have now in place for getting the information that we need.

I think everyone does provide the information that we request when we request it, but we do not, perhaps, have the correct system for eliciting what we need.

MR. CUSIC: May I ask a question, please, of Commissioner Grundfest, clarifying a point, perhaps?

Sir, you keep using the term "soft dollars" and it sounds like you are separating it from all commission business done, which is done for the purpose of paying for research.

Is that what we are trying to define here?

COMMISSIONER GRUNDFEST: No. I think I am using it as a shorthand, and people have raised the point before that as a shorthand, it has some real infirmities, because people use the terms to apply to different things.

The basic thrust of the point, very simply, is that perhaps the people with ultimate responsibility for the investment of pension funds and the like are not getting full information with regard to what is going in and what is coming out at the fund manager level.

You might call some of it "soft dollars." You might call some of it "research services." Personally, I do not care. You could have the whole conversation without ever using the word "soft dollars."

But as Mr. Binns put it, if we are paying the fee and if we think that fee is something that covers full freight, and if we then find out that you are getting rebated back on something else in a way that we thought we were paying you for, well then, maybe we are paying you too much, so we will pay you less.

The whole argument can be made without every saying the words "soft dollars," and that would avoid the nomenclature problem, but I think the nomenclature problem is neither exacerbated nor ameliorated by using it in that context.

MS. MCGRATH: Well, I wish you had not said that, Joe, because I want to use the term right now.

The question that is directed to the pension plan people and the money managers, which is basically, absent the 28(e) safe harbor, would anyone feel comfortable enough with the adequacy and the accuracy of monitoring the costs and benefits of what you buy through this indirect route to continue making the purchases that way?

I did not use it, see?

COMMISSIONER GRUNDFEST: I said it could be done.

MR. SCHWAN: We would have no problem at all. We would subject the purchases of proctor services to the same criteria as hard dollars or the other kind.

MS. MCGRATH: How about you, Mr. Binns?

MR. BINNS: I am not sure I understand what you want me to answer.

MS. MCGRATH: If there were no Section 28(e) safe harbor, do you think the data that you are getting is enough to satisfy your fiduciary responsibility that the money is being appropriately spent on behalf of the pension plan beneficiaries?

MR. BINNS: I would want to look into that further before I give you any definitive response. I'll tell you later after I have looked into it more.

MR. BAHR: I think we would continue to operate in that manner.

I think the clarification of what qualified was the important part, particularly when it got down to hardware and software, but I think we would probably continue at the level we are.

I think the question, when it comes up to soft dollars was, Commissioner Grundfest, the full-service brokers are also providing research, and they have a budget of $65 million. So whether we are paying them for theirs or paying a third-party provider, both parties are providing research and, in effect, let's -- and when we get down to 4 or 5 cents a share, we are getting as close to the net markets as we are probably going get without getting there fully.

The disadvantage of liquidity, while 90 percent of orders are probably working orders within the pension fund, if liquidity disappears completely, then I think when some of my friends here are willing to buy what I am going to sell them, they are really competing with me and betting that I am wrong and they are right in making the purchase.

I doubt if they are going to provide a service to lose money for very long, to any of us.

MR. RIES: I think one serious question is that if 8(e) were eliminated you would have a very serious ERISA problem for the money managers in that they would not be able to use the research for other clients who did not get the direct benefit from it.

So I think 28(e) is essential to being able to do this in ERISA plans.

MR. KETCHUM: With that, this roundtable today is somewhat unique in that it involves two related but discrete topics.

We now take a short break before removing on to the related topic of payment for order flow between brokerage firms.

The participants in that second panel will vary substantially from the first.

I would like to thank all our participants today. I thought it has been excellent discussion, providing the Commission a great deal of information and very helpful views. Thank you, again.

(Whereupon, a short recess was taken.)

P A R T I I

11:55 a.m.

CHAIRMAN RUDER: Could you please take your seats? We will begin the next portion. By way of transition we are ready to begin.

It is possible of course to pay not in soft dollars but in hard dollars, and we are going to deal with the second topic, payment for order flow practices.

Mr. Ketchum.

MR. KETCHUM: Thank you, Chairman Ruder.

The question of hard dollar payments, particularly those payments made by dealers attempting to attract business handled by other brokerage firms, has been one again that has been controversial and focused on a great deal in recent years.

In particular, there is a perception that the Commission, I think elsewhere -- that this business has increased substantially in the last year or two.

I think for the benefit of the Commission and its staff it would be helpful first to begin this discussion by a focus on precisely what had been the developments in the business and how widespread payment for order flow is, both with respect to over-the-counter securities and securities that are listed on an exchange.

Before looking to the market participants on that, I note that we are privileged to have Joe Hardiman, the president of National Association of Securities Dealers, as well as John Watson, the President of Security Traders Association. Both of those organizations in recent months have been attempting to quantify through studies the scope and character of this business.

I wonder if you two would like to begin with some description of your studies?

MR. WATSON: Mr. Ketchum, I will certainly yield to Mr. Hardiman as far as the figures are concerned because they have been conducting the examination.

MR HARDIMAN: During the year, the month of June, the NASD surveyed some 500 active NASDAQ market makers as well as SOE's order entry firms. Therefore, any findings that we have to date are applicable only to those groups and to those firms that are respondent.

We have had some 435 usable responses to date, and the remaining 65 comprise some of the larger firms in the industry. Hence, I would suggest to you that the information that we have today is preliminary and incomplete, and maybe should not be the basis for reaching any judgments.

The information was sought for the second half of 1988 and for the first quarter of 1989.

As a general statement, we would say that the hard dollar payments generally reflect competition of non-integrated dealers to attract order flow of non-integrated retail firms.

Basically, retail competition is relied upon to assure the benefits of flow to the investing public through lower transaction costs.

Of those firms responding, 62 firms of 435 responding indicated that they were making such payments. Of those, 50 are what we would categorize as general securities brokers, 5 are what are typically known as wholesale dealers, and 5 are third market makers.

In those firms that make hard dollar payments to some 241 firms that receive such payments, 233 responses the firms did not either make or receive hard dollars -- and by the way, we included soft dollar payments in their survey, and there were some 108 firms that made soft dollar payments for a variety of institutional clients. So of the 435 that responded, only 62 are actively engaged in the business.

For nearly all the payors and the payees, the amount paid ranges between 1 and 2 cents per share.

Data received thus far for the last six months of 1988 and for the first three months of 1989 do not indicate increases in payments that are significantly greater in the increase in non-block volume.

Most of the payors have one or two payees, but some six firms have over 20 counter parties that they are making payments to.

The largest 10 payors account for about 90 percent of the payments that were reported to us thus far.

Conversely, the recipients of the payments are nearly always at one or two counter parties, although one did report receiving hard dollar payments from as many as seven payors.

The largest ten recipients accounted for about 65 percent of the total received.

The total amount of payments in terms of dollars appear to be small in relation to both share and dollar volume and aggregate industry revenues. Indeed, we are taking a look at something that represents less than one-tenth of 1 percent of the dollar volume of trading.

Payments are usually made involving both exchange listed, NASDAQ and non-NASDAQ OTC securities. They are usually made on stocks priced below $1 per share.

Comments by our firms indicate that best execution is not compromised and that disclosure in accordance with 10(b)(10) is made to the customers.

Indeed, most payments tend to be made to attract order flow to completely automated execution systems that are programmed to execute at the inside quotation. This has been confirmed by our examining staff through independent examinations of a number of these firms, and as well as by a 1985 survey which the NASD conducted of the firms that were actively engaged in that business at that time and discovered very little problems with the best execution requirement that we have for our market makers.

That is a summary of the information that we have received to date. However, again, I want to label it as incomplete and preliminary.

MR. KETCHUM: Mr. Hardiman, was there any indication in the survey as to whether the percentage of business directed as the result of payment for order flow differ significantly as between listed NASDAQ and non-NASDAQ securities?

MR. HARDIMAN: I am not sure that question was asked specifically on the questionnaire and I am not familiar with the percentage.

I would suspect that -- this was primarily directed to NASDAQ market makers and OTC market makers rather than to exchange firms as a category or even exchange specialists -- that the responses would be heavily weighted toward the NASDAQ and non-NASDAQ markets.

MR. KETCHUM: I should note at the beginning of this discussion, since our panel has changed substantially, that again, for the benefit of our transcriber, it would be extremely helpful if you can identify yourself at the beginning of any statements.

In the connection with the NASD survey results, obviously, it suggests that -- Mr. Hardiman suggested -- that a primary part of the developments in the payment for order flow area has been an attempt by non-integrated firms, or wholesale dealers, to compete to attract retail order flow from, again, non-affiliated firms.

Madoff Investment Securities and Herzog, Heine and Geduld are both well know for your trading capabilities. I think it has generally been suggested that you are involved somewhat in paying for order flow.

It would be helpful, Mr. Madoff, if you could give us some perception or impression of the extent of payment for order flow practices, both in your business and system-wide, and whether you are seeing as a result of your payment for order flow activities an increase in your business.

MR. MADOFF: Well, payment for order flow I would imagine would represent about 50 percent of our overall order flow. In other words, we probably -- if we had to put a number on it, I would say that 50 percent of the order flow that we receive is paid for. We pay a penny a share for our order execution.

The answer to the question, has our business increased since we started payment for order flow, I would have to say yes. But it is hard for us to define whether or not the order flow increased solely because of payment, because at the same time that we were initiating paying for order flow, we were developing a computerized trading system which totally automated the order flow that we received, so that a firm sent us order flow not only because they were receiving payment, but also because they get a totally automated execution.

MR. KETCHUM: From the standpoint of made up investment securities firm, do you have any view as to the percentage of payment for order flow business that is occurring in listed securities as opposed to over-the-counter securities?

MR. MADOFF: I am not privy to the intimation as far as payment for order flow on exchanges. So I really cannot answer that.

MR. KETCHUM: From your business standpoint, does your firm receive a greater flow of listed orders as a result of payment for order flow arrangements or is it mixed?

MR. MADOFF: Well, we do not pay for over-the-counter order flow. We strictly pay for listed order flow.

MR. KETCHUM: Mr. Geduld?

MR. GEDULD: I would say that approximately 23 percent of our share volume is derived from payment for order flow.

This was something that basically started on a larger scale, I guess, five or six years ago. I think that some retail firms developed an idea that they had a commodity that was worth selling, and they took it out to the wholesale industry and said, "We have got some order flow here and we think it is worth something."

I think then the competitive nature of the marketplace made one decide, do you want to stay as you are as far as market share goes, or do you want to give up some of their market share. I think that was our determination whether we were going to pay for order flow or not.

MR. KETCHUM: From that standpoint perception, we have representatives from both Charles Schwab and Quick and Reilly, which I guess meet the description of non-integrated firms with respect to market making capacity.

Are you increasingly insisting for payments for order flow and if so, how do you go about that, and how do you go about making your decisions as to which firms you do business with?

Mr. Stupski?

MR. STUPSKI: Though we make decisions on whom to deal with on the basis of clearly best execution for the customer, overall service, willingness to stand up to markets, level of automation, total cost to us, and included in total cost to us is payment for order flow, but on the listed side as well, the various exchanges compete on the basis of price, transaction prices and floor brokers.

So from our standpoint it is part of the total net cost of doing business.

MR. QUICK: We place all our over-the-counter business through Sherwood Securities, and we have managed to automate 80 percent of the order execution there, and we are satisfied that our customers are getting the best execution.

Those automated systems that Mr. Hardiman referred to that have been audited by their examiners are doing the over-the-counter orders on the inside market.

The only thing that is left to chance is the pink sheets and some of the larger orders, but we are confident that those are handled in a proper way.

MR. KETCHUM: Do you receive guarantees with respect to the inside market executions, or is that something you just simply monitor?

MR. QUICK: It is guaranteed.

MR. KETCHUM: Is that for all size trades that may route to the particular firm?

MR. QUICK: As far as the automated goes, it is only on certain size orders.

COMMISSIONER GRUNDFEST: Excuse me, Mr. Ketchum,