# THE S.E.C. AND THE SECURITIES MARKETS -- SOME CURRENT DEVELOPMENTS

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There have been a great many significant developments within the securities industry in recent months. Time requirements, however, preclude discussion of even a few of these in full detail. This commentary, therefore, will be limited to a brief discussion of three areas of current interest to the Securities and Exchange Commission, the exchanges and the securities industry as a whole.

The three topic areas to which my remarks will be addressed involve the current status of the antitrust cases, the entrance of banks into the "mutual fund" business, and the very broad area of commission rates, which may include commission splitting, give-ups, the third market, Rule 394, volume discounts and others.

In the antitrust area, there have been several new developments that merit attention. Not the least of these is Judge Hoffman's recent decision in Kaplan v. New York Stock Exchange dismissing plaintiffs' complaint which challenged the New York Stock Exchange commission rate schedule as a *per se* violation of the antitrust laws. You will recall that this action was brought by Mr. Kaplan, among others, as a shareholders' derivative suit for the benefit of some five mutual funds. In his complaint, Kaplan alleged that the New York Stock Exchange conspired with its members to set and fix minimum commission rates charged to the public (including the funds) on brokerage transactions executed through the Exchange. Kaplan argued that the Exchange's action in promulgating a commission rate schedule amounted to a restraint of trade in violation of the Sherman Act. As a result of such alleged price fixing, Kaplan alleged, the public and the funds were injured to the extent that they were charged higher commission rates than would have prevailed if rates had been set by competition in a "free and open" market.

Basically, the court found that:

> "Since the plaintiffs have attacked the legality of the Exchange rules and their prescribed rates of commission solely on the grounds that the fixed rates are illegal, the holding in Silver v. New York Stock Exchange, 373 U. S. 341 (1963) is a complete bar to their claim. Rules adopted by an Exchange under the authority of the [Exchange] Act are not illegal *per se*."

The court also stated that:

> "It is not suggested by the plaintiffs here that the rules are not uniformly applied, that the schedules are discriminatory or that the power has been used to eliminate competition beyond that elimination inherent in any authorized price fixing."

Finally, it is important to note that the court relied upon the fact that the Commission exercises "a general and continuing power" with respect to Exchange commission rates. The court indicates that if plaintiff believed that commission rates were too high, his complaint should have been addressed to the Commission as the agency having jurisdiction under the Exchange Act.

Before going further, it may be best to stop briefly and review Silver v. New York Stock Exchange, 373 U. S. 341 (1963), the leading Supreme Court case in this area of the law.

Mr. Silver, as you will recall, was a Dallas non-member broker-dealer who had tentative approval from the New York Stock Exchange with respect to arrangements with certain member firms for direct wire connections with their offices to provide him with quotations and other information essential to his business. When subsequent collective action by the Exchange and its members caused this wire arrangement to be severed without notice or explanation, and without affording him an opportunity to be heard, Silver brought suit against the Exchange alleging violation of the Sherman Act. The Supreme Court found that, had this action by the Exchange and its members occurred in a context free from other Federal regulation, such action would have constituted a *per se* violation of the Sherman Act. "[This was] a group boycott depriving petitioners of a valuable business service which they needed in order to compete effectively as broker-dealers in the over-the-counter securities business." The decision indicates, however, that while collective action taken by the Exchange and its members pursuant to its statutory authority to make rules is not illegal *per se* under the Sherman Act; nevertheless, where such action would not serve the purposes of securities regulation, there remains no policy under the Federal securities laws which precludes the application of the antitrust laws or immunizes the Exchange's conduct. Furthermore, the court pointed out that since nothing in the Securities Exchange Act gave the S.E.C. the power to review particular adjudicative decisions of the Exchange in enforcing its rules, the remedy of review must therefore be found in the judicial branch.

As a result of the principles of law laid down by the Supreme Court in Silver, Judge Hoffman concluded that where the action of the Exchange is necessary to effectuate the policies and purposes of the Exchange Act, and where the S.E.C. has the power to alter or supplement such Exchange action, there is no need for initial resort to the antitrust courts. Judge Hoffman found that the Commission exercises a general and continuing power to change, alter or supplement the rules of the Exchange, fixing the reasonableness of commission rates pursuant to an obligation under the Act to do so and, therefore, since review is afforded within the scheme of Federal securities regulation, plaintiffs should resort to the avenues created by that regulatory pattern.

The Commission's concern with commission rate problems has been evident for some time. Indeed, in Kaplan we sought to file a brief as amicus curiae, but the court rejected our offer. Nonetheless, the court appears to have accepted our view that (1) an exchange is not per se violating the antitrust laws by merely promulgating rules respecting commission rates, and (2) that questions, beyond per se dealing with commission rates and structure under the scheme of the Exchange Act, should first come to the Commission where (as here) it has authority to deal with the matter.

The Commission could thus exercise its jurisdiction in these sensitive areas before ad hoc decisions by various courts on such problems create new complexities and possibly diverse standards. This view, we believe, carries out the purpose of the Exchange Act in preserving the uniformity and Commission jurisdiction there intended without sacrificing the policy of the antitrust laws. The Commission would view the issue under the regulatory standards set out by Congress in the Exchange Act and determine what conduct is made necessary by that Act. Obviously, the courts will be in a position to review the Commission's action in any Commission proceeding which may involve these problems.

Since the report of the Special Study of Securities Markets, we have been giving careful consideration to such matters as exchange practices in respect of off-floor trading by members with non-member dealers (Rule 394 of the New York Stock Exchange), which I shall get to in a moment, the possibility of volume discounts, membership of institutions in exchanges, commission rate level and reciprocal business.

The problem raised in Kaplan is only one part of this larger pattern of regulatory problems facing the Commission.

Another development with significant antitrust overtones is a charge being publicly made, although not yet brought to court, by an over-the-counter dealer that the listing of Chase Manhattan Bank stock on the Big Board has caused a serious detriment to his market-making capacities in this stock due to Rule 394 of the Exchange. Rule 394, you will recall, is the one which in effect prohibits a member firm from dealing in a listed security from any place other than on the Exchange without specific permission of a floor official.

As in the case of any justiciable controversy, especially one with broad national implications, one can find knowledgeable opinions to support almost any position. There are those who feel that stock exchanges should have no exemption from the antitrust laws, no matter what the sphere of activity. Others feel that an absolute exemption should be granted. There are innumerable shadings with respect to these polar positions. It has been said that the Congress recognized that certain exchange functions might otherwise be deemed violative of the Sherman Act, which had then been in effect for 44 years, and that, by failing to prohibit them in the Exchange Act, they were implicitly sanctioned. This argument was explored, at least as to the facts there presented, by the Silver case. Others point to the Maloney Act of 1938, which subsequently became Section 15A of the Exchange Act. It provides an explicit exemption for national securities associations formed and operated under its provisions. This, of course, adds fuel to the argument of those who claim that Congress did not intend that the exchanges should have such an exemption. Otherwise, they argue, it would have been granted explicitly, in 1938 if not originally.

Thus the battle lines are being drawn with respect to alleged antitrust activities in the securities market place, and many interesting and significant judicial controversies inevitably lie in the days ahead.

Concerning developments in the investment company field, many of you are no doubt aware of the present public debate over the proposed "Bank Collective Investment Fund Act of 1965," more commonly known as Senate Bill 2704. Also of interest to you in this area is the recent action taken by the S.E.C. granting the First National City Bank certain exemptions from the Investment Company Act of 1940 with respect to the proposed registration of its managing agency accounts under that law.

S. 2704, originally introduced during the 88th Congress as the "Bank Collective Investment Fund Act of 1963," is a bill to provide for the regulation and supervision of collective investment funds by the

Federal banking agencies. This proposed bill would amend the Federal securities laws so as to exclude interests in the collective investment funds from the definition of a security in the Securities Act of 1933 and the Securities Exchange Act of 1934, and to exclude the collective investment funds themselves from the definition of an investment company in the Investment Company Act.

Unlike the bank depositor who has the absolute right to receive the fixed amount he has deposited, the investor in the bank commingled fund will buy a pro rata share of a pool of largely equity securities, and the value of his investment will fluctuate in accordance with the market performance of the pooled portfolio. The Commission has taken the position from the outset that this is indistinguishable from the purchase of a share in a mutual fund. The only difference is one without substance or significance to our responsibility for investor protection -- namely, that a bank will sponsor and manage the mutual fund rather than an investment banker, investment adviser, insurance company or some other organization. Accordingly, our position necessarily followed that the units of interest in the commingled fund must be registered under the Securities Act of 1933 and the fund itself registered under the Investment Company Act of 1940.

The American Bankers Association, the major proponent of S. 2704, has testified before the Senate Banking and Currency Subcommittee on Financial Institutions, asserting that the S.E.C.'s inspection of the mutual fund type operation is expensive, overlapping and unnecessary since bank books are checked by three existing regulatory agencies. Of course, our answer is in part that this argument entirely misconceives the nature, purpose and thrust of bank regulation as distinguished from securities regulation. Bank regulation has the objectives of controlling the flow of credit in the monetary system, the maintenance of an effective banking structure and the protection of depositors. These do not provide investor protection, which is the precise focus of the Federal securities laws.

Furthermore, the president of a large mutual fund and a governor of the Investment Company Institute of New York said in his recent testimony before the Senate Banking and Currency Subcommittee: "the public is entitled to have the vital protections of the federal securities laws applied to all mutual funds whether they be sponsored by a bank, insurance company, investment counseling firm or anyone else." The National Association of Securities Dealers, Inc., as well as officials of mutual fund organizations and the insurance industry, also testified against the bill. Even the Comptroller of the Currency declared the measure "wouldn't

serve the public interest," contending that the regulations of his office and those of the S.E.C. are complementary. This position taken by the Comptroller is of particular significance in view of the fact that he was the moving sponsor of S. 2704 when it was originally introduced in the 88th Congress in 1963.

With respect to action taken by the Commission granting First National City Bank certain exemptions from the 1940 Act, the Commission was obliged to find that such exemptions were necessary or appropriate in the public interest, consistent with the protection of investors and that the purposes for which such exemptions were granted were fairly intended by the policy and provisions of the Act. Congress established such guidelines to take care of the special situations that might be either overlooked or were not foreseen at the time the legislation was being drafted. In such special situations, a showing is required that the compliance from which the exemption is sought will not frustrate the Act's objectives and policies.

In an opinion handed down on March 9th, the Commission held that First National's proposed arrangement is such a "special situation" for two reasons. Firstly, as pointed out in our opinion, it was not until a change in the banking regulations occurred in 1963 that the eventuality of a commingled managing agency fund account became possible and, secondly, such managing agency fund account is substantially different, both in purpose and nature of operation, from the bank-dominated investment companies which led to the passage of the provisions of the Investment Company Act. As a basis for granting an exemption under the 1940 Act, we have held in several Commission opinions that the test for the appropriateness for such an exemption "largely depends upon the purposes of the section from which an exemption is requested, the evils against which it is directed, and the end which it seeks to accomplish."

With regard to potential conflicts of interest, it was the Commission's opinion that the Bank has shown substantial safeguards. Not only would it be subject to regulation by the S.E.C., but the managing agency account is regarded by the banking authorities as an aspect of the Bank's fiduciary functions and, therefore, will be subject to the supervision and regulation of the banking authorities from that point of view as well.

One of the Commissioners came to the conclusion that the conflict of interest features in the Bank's proposal were not sufficiently ameliorated and he, therefore, was unable to find that it was necessary or appropriate in the public interest to grant the exemption.

The third area of this commentary will be concerned with the problems currently confronting the S.E.C., the exchanges and the securities industry with respect to the very broad subject of exchange commission rates.

As is the case with the New York Stock Exchange, all regional exchanges have minimum commission rate schedules. With the exception of the Midwest Stock Exchange, the major regionals have either adopted new rules or implemented existing ones allowing members to share their commissions with broker-dealers who are not members of the exchange, a practice prohibited by the New York Stock Exchange.

As you know, however, the number of firms holding memberships on one or more regional exchanges, as well as on the Big Board, is increasing; moreover, many securities listed on the Big Board are also traded on one or more of the regionals. As a result, firms which are members of the New York Stock Exchange and of one or more regionals may trade in dually listed stocks on the regionals and split their commissions with brokers who are non-members of the New York Stock Exchange or are permitted to share commissions under regional rules. This division of commissions may be substantial, amounting to 40% or more of the commission received by the executing member. The alternative for a fund desiring to reward brokers for various services is execution on the Big Board, with commission-splitting limited only to other New York Stock Exchange members.

Partly as a result of this erosion of the prohibition of the commission-splitting rule, the amount of New York Stock Exchange business (based on the market value of securities traded on all the nation's registered stock exchanges) has been declining percentage-wise in recent years. In 1962, transactions on the Big Board accounted for approximately 86 1/2%, in 1964 it was 84%, and last year 82.4%.

Another factor in the percentage decline in New York Stock Exchange business is the dramatic growth of the open-end investment company. At the time of the passage of the Investment Company Act of 1940, the total assets of mutual funds then registered with the Commission amounted to something less than $500 million. As of December 31, 1965, the Commission estimates that registered mutual funds had a total aggregate asset value of approximately $38 billion. This sizeable jump has taken place for the most part in the past 10 years, and increased by more than five and one-half billion dollars in the last six months of 1965 alone -- a phenomenal growth rate.

Although the value of securities held by mutual funds has increased markedly due to general market appreciation, more than half of the growth may still be traced to new dollars coming to them from investors, substantially exceeding those dollars paid out to shareholders redeeming their shares. The responsibility for the trading and investment of these monies has resulted in the mutual fund managers being among the most sought-after customers by securities brokers. The value of such business may be illustrated by the fact that in 1965 brokerage commissions paid by mutual funds on purchases and sales of portfolio securities have been estimated at more than $100 million.

Although the mutual funds and other institutional investors buy and sell securities in such large quantities, no exchange, as you know, provides a commission rate structure permitting a volume discount. Knowing that the commission is a fixed cost, fund managers have attempted, for their own best interest, to develop ways to gain some beneficial advantage from this situation.

One such procedure consists of what is generally and colloquially known as the "give-up." This involves a practice where a fund manager or other large institutional investor, as the case may be, directs an executing broker to give away a portion of the commission charged on the mutual fund transaction to one or more other member firms, a practice presently permitted by the New York Stock Exchange, but only as between New York Stock Exchange members. This practice may also be used effectively to compensate non-Big Board members of a regional exchange having dually listed securities for past services rendered to the fund, such as research or sales of fund shares, or to provide incentive for future sales of fund shares by channeling executions to the regional exchanges.

It will thus be seen that a dual member receives the same net amount of commission in either case, but the fund manager has achieved broader diversification for his give-away largesse. The "give-up" is a valuable commodity, and it has been suggested that many managers would not favor a volume discount even though such a discount would directly benefit their fund, since it would, as I have said, cut into the pool available to create sales incentive.

This commentary would not be complete without at least a reference to the so-called "third market," its impact on the exchange markets and the interplay of its activities with the Big Board's Rule

394, to which a brief reference has heretofore been made. The third market is, as you know, a negotiated, over-the-counter market in listed securities. Its existence appears to be primarily due to two factors. First, the lack of a volume discount makes it possible in some instances for a non-exchange member to negotiate trades as principal at prices away from the current exchange market, but which still affords a better net figure, due to the larger commission which would have to be charged on the exchange. This ability to "undersell" the exchange, when it exists, is more pronounced in the large, or "block," transactions since the exchange commission rises, of course, in direct proportion to the total volume of securities bought or sold.

The second factor is the ability of some well-capitalized market-makers to handle blocks of rather large size under particular circumstances, while specialists on the exchange at any given moment may not be able singlehandedly to absorb them. In other instances, the fixed commission rate is a deterrent, as is to some extent the mandatory "print" of the transaction on the tape, which some institutional investors would in certain situations like to avoid for a variety of reasons. In addition, the handling of a large block on the exchange may necessarily take time, when time may be of the essence.

The use of the third market is, however, not limited to block transactions. Some non-members apparently like to deal for their customers and for themselves outside the strictures of the exchange commission rate structure. The third market also provides a means by which the small broker-dealer may earn a commission on smaller trades in listed stocks, thereby remaining competitive with a member broker and avoiding a major risk of losing a customer to a member house.

As previously pointed out, Rule 394, except in very special circumstances, prevents a member from taking his customer's order to the third market. Interesting questions are raised by Rule 394 which include not only the extent of a broker's responsibility to obtain the best possible execution for his customer and the impact of possible antitrust action, but the possible need for a volume discount as well. I am not unmindful of the strong opposition in a number of quarters of the broker-dealer community to a volume discount.

At the other end of the spectrum, however, absent such development, lies the possibility that investment adviser managers will take action to gain membership for subsidiary broker-dealers on regional exchanges. As you know, during 1965, managers of two of the largest and

most influential of such funds did just that with respect to membership on the Pacific Coast Stock Exchange and, thus, theoretically at least, they will be able to reduce substantially their brokerage costs by transacting brokerage business through wholly-owned broker-dealer subsidiaries. In this connection, it is noted that the subsidiary of one such mutual fund manager, as a member of a regional exchange, earned over a quarter of a million dollars during the last four months of 1965 over and above the savings to the fund with respect to its portfolio transactions.

A current study of Rule 394 by the New York Stock Exchange and the Commission will attempt to establish equitable and meaningful solutions benefiting the public investor and the exchanges, as well as the small broker-dealer.