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The New York Stock Exchange and the Commission Rate Struggle[†]

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I

THE PROBLEM

THE LIFEblood of the brokerage business is the commission system. The New York Stock Exchange (NYSE) commission rate structure is the tie that binds its members together. That structure, supported by six restrictions, is a fortress designed to safeguard the commission system and to prevent price cutting:¹ (1) Commissions must be charged at minimum rates on all transactions executed by members on behalf of others in NYSE listed securities. This includes off-board transaction. (2) Commissions charged must be net and free from any rebate, return, discount or allowance, direct or indirect. (3) All nonmembers of the Exchange, whether professionals engaged in the securities business, institutional investors, or members of the public, pay the same rates. These are substantially higher than the rates charged Exchange members. (4) The minimum rates applicable to nonmembers must be charged whether or not the customer receives various ancillary research or other services, the cost of which is taken into account in establishing the rate structure. (5) Commission rates are computed on the amount of money in each round lot transaction (one hundred shares); there is no discount on volume transactions so that the commission for a transaction of 1,000 shares is ten

[†] An earlier version of this paper was prepared for presentation before the Committee on Securities Regulation of the American Bar Association Committee on Corporations, Banking, and Business Law at the Annual Meeting in Miami Beach, Florida in August, 1965 and published in 21 BUS. LAW. 159 (1965). This article is a substantial revision of the earlier study, in the light of developments to November 12, 1965, and the very valuable comments and criticisms received from my colleagues at a Boalt Hall faculty seminar on the topic. The *Business Lawyer* has graciously consented to the publication of the revised paper in the *California Law Review*.

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¹ The NYSE commission rates and service charges are set forth in the NYSE constitution, article XV. CCH NYSE GUIDE ¶ 1701.

times that on one hundred shares. (6) Members must obtain permission from the Exchange before effecting a transaction in a listed stock off the floor of the Exchange, either as a principal or agent, unless the stock is on the exempted list;² however, a member of the Exchange holding a membership or associate membership in another exchange located in the United States or Canada may charge the commission rates prescribed by such other exchange in respect of transactions made on that exchange.

An essential element of the exchange concept is a restricted membership. The idea is to have all transactions in NYSE listed securities conducted on the floor of the Exchange. Securities are to be bought and sold at public auction with prices flashed by electronic means to brokers' board rooms throughout the nation. The rate structure clearly envisages a market made up of large numbers of public customers dealing in relatively small quantities of securities. The system showed few stresses so long as the bulk of investors were of this type.

In recent years, however, an assault upon the rate structure has come from two sources: nonmember professionals and institutional investors. First, there is a natural conflict between NYSE member firms and nonmember securities firms doing a public brokerage business. The nonmember firm frequently is in the position where it must accept brokerage business in stocks listed only on the NYSE for fear of losing its customers; the ban on NYSE member firms sharing commissions with nonmember firms precludes the nonmember firm from receiving any portion of the commission charged the customer; and even though the nonmember firm has certain fixed overhead costs, competition with the NYSE member firm precludes it from charging an additional commission to that charged by the member firm for executing the order. Second, over the past several decades, and especially since World War II, there has been an enormous growth in share ownership by institutional investors—banks administering trusts and pension funds, insurance companies, educational institutions, foundations, and mutual funds.³ As institutional

² This is the famous NYSE Rule 394, CCH NYSE GUIDE ¶ 2394. The Exchange has issued a blanket exemption from the rule for most listed, guaranteed and preferred stocks. The list is published in CCH NYSE GUIDE ¶ 2394.10. Members are expected to execute transactions in these stocks on the Exchange unless a better market exists elsewhere, taking into account the price and size of the transaction. Subject to these restrictions, members may trade off-board in these stocks if a better execution may be obtained.

³ It is estimated that as of December 31, 1961, 22% of the outstanding common and preferred stocks were held by institutional investors, including bank administered personal trust funds as against 76% owned by domestic individuals. See Securities and Exchange Commission, *Report of the Special Study of the Securities Markets*, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 2, at 837 (1963) [hereinafter cited as SEC, *Special Study*]. Institutional investors' holdings in common and preferred stocks traded on the NYSE climbed from 12.7% at the close of 1949 to 20.1% at the end of 1963. See 1964 NYSE Fact Book 7; 1965 NYSE Fact

portfolio managers have become more sophisticated, they have bridled at the idea of paying retail prices when buying and selling securities in wholesale lots. As one fund manager put it:

I don't see why I can't get quantity discounts on my funds' quantity purchases and sales of securities, rather than have to pay the same commission rate paid on a 100-share trade. My order actually takes less effort, because I'm not getting the same service the little fellow is getting. I know what I want to buy or sell, so the broker is reduced to order-taking.⁴

In actual practice, the commission rate fortress was never impregnable, and with the pent-up forces unleashed by nonmember professionals and institutional investors, it has become more and more difficult to defend. Indeed, it is now little more than a Maginot Line which enterprising price cutters may bypass if they but adhere to the form, rather than the substance, of the antirebate provisions. Although a number of these business practices are familiar to corporate lawyers, it may be well to describe them briefly.

A. The "End Run"

One method of circumventing the antirebate provisions is the so-called "end run."⁵ Many securities dealers who are not members of the Big Board are members of one of the regional exchanges where some NYSE securities have a dual listing. When the nonmember firm accepts an order from its own customer involving a transaction in a NYSE security not listed on a regional exchange of which he is a member, he must turn to a NYSE member firm to handle the order. Although the NYSE member firm is forbidden to share its commission directly, it may reciprocate by directing some of its own commission business in multiple listed securities to the correspondent for execution by him on a regional exchange, thereby enabling the correspondent to earn legitimate execution commissions.⁶ Thus, although the NYSE member may not split commissions earned on transactions in Big Board securities directly, it may return a cash equivalent in the form of profitable commission business on securities transactions which it could have handled itself.

Book 25; NYSE DEP'T OF RESEARCH AND STATISTICS, INSTITUTIONAL SHARE-OWNERSHIP—A REPORT ON FINANCIAL INSTITUTIONS AND THE STOCK MARKET (June, 1964). Hillery, *Wooing the Funds—Institutional Accounts Attract More Attention Among Securities Firms*, Wall Street Journal, June 6, 1965, p. 1, col. 1 (Wall Street Journal citations are to the Pacific Coast Edition).

⁴ Nuccio, *Mutual Funds: A Reaction to the S.E.C. Report*, N.Y. Times, Aug. 12, 1963, p. 29, col. 3.

⁵ See Silberman, *Securities End Run*, Wall Street Journal, July 23, 1964, p. 1, col. 6. Other permissible methods of bypassing the antirebate provisions are discussed in SEC, *Special Study* pt. 2, at 302-10 (1963).

⁶ NYSE Const. art. XV, §§ 1, 2(c), 8; CCH NYSE GUIDE ¶¶ 1701, 1702, 1708.

The line between permissible and impermissible reciprocity under the antirebate provisions is razor-edged: "Reciprocity arrangements representing 'generated' or 'allocated' business violate the antirebate rule; reciprocal business based on the [regional] member's 'hope' that he can secure return business is legitimate."⁷ The most common arrangement is for the NYSE member firm to return brokerage business which will yield one dollar of commissions for each two dollars of commissions it earns on referred business. The arrangement has obvious attractions for both parties. The ratio always favors the NYSE firm. On the other hand, the correspondent must service his own customers or perhaps lose them altogether; for him some compensation on referred NYSE business is better than none.

There are many variations on this theme. For example, the NYSE member can direct some of its over-the-counter business to its correspondent even though it maintains a well-staffed over-the-counter department. The NYSE does not object to these reciprocal arrangements per se, even though based upon a two for one or three for one ratio, so long as the business directed to the correspondent is bona fide business, and not "generated" or "allocated" business, and so long as no cash is used to make up a deficiency in income.⁸

In addition to these reciprocal commission arrangements between NYSE members and the members of regional exchanges, various other methods of compensating the correspondent broker are permissible. These include the furnishing of special services such as installation and maintenance of wire or ticker services, clearance of non-Exchange transactions, office space, special research reports, and promotional materials and displays. These services may in fact be of substantial value to the correspondent broker.

The effect of these practices insofar as they relate to NYSE securities with a multiple listing on a regional exchange has been to increase the volume of transactions on certain of the regional exchanges, notably the Detroit, Midwest, Pacific Coast, and Honolulu stock exchanges, at the expense of trading on the Big Board. Other regional exchanges have become interested in developing this type of reciprocal business and it seems bound to grow at the expense of the Big Board.⁹

⁷ SEC, *Special Study* pt. 2, at 305.

⁸ *Id.* at 304.

⁹ Subsequent events have rendered this statement obsolete. The "end run," as here used, restricts the sharing of commissions to other members of the regional exchange. The SEC Special Study, published in 1963, mentioned, albeit casually, that of the six major regional exchanges, the Detroit, Pacific Coast, and Cincinnati exchanges allowed discounts to nonmember professionals under certain circumstances. SEC, *Special Study* pt. 2, at 300. Thereafter, NYSE members commenced to divert orders in NYSE listed securities to the

The long-term effect of this trend will be to make the primary NYSE market in these stocks thinner and, so the Exchange contends, thereby tend to cause wider fluctuations in price. However, over-all market depth must be measured not only by taking into account the primary NYSE market, but by including the regional exchanges and the third market as well.¹⁰ Although these may be regarded as secondary markets, they provide depth and stability to the primary market; they also supply a competitive factor not otherwise present. For example, if a large order to buy comes into the NYSE which cannot be matched off against orders to sell in the same amount, the specialist on the floor is in a position to raise the price as a condition to making a sale. He also possesses superior information arising from his knowledge of orders on his "book." Furthermore, since in practically all cases there is only one specialist in a listed stock, the public customer and his broker may be at a competitive disadvantage if they are forced to deal solely with that specialist. It is likely that the specialist's spread will tend to become narrower, if the buyer may shop the third market or regional exchanges for all or a part of his purchases in order to ascertain whether he can obtain a better execution outside of the NYSE.

B. The Give-Up or Directed Split

A further erosion of the commission rate structure has arisen in connection with the handling of portfolio transactions of mutual funds by NYSE members through a pattern of practices known as "reciprocity."¹¹

When a mutual fund buys or sells securities listed on the NYSE through a NYSE member, the antirebate rule prohibits the shaving of commissions on volume transactions. At the same time, however, under the Exchange rules a member is permitted to split his commission (excluding the floor brokerage and execution and clearance commission which must be retained by the firm actually performing these services) with fellow NYSE members, if directed to do so by the customer, whether or not such members perform services in connection with the transac-

Detroit and Pacific Coast exchanges which allowed members to split commissions with any nonmember of the exchange who was a member of the National Association of Securities Dealers. See Silberman, *supra* note 5. The stampede of other regional exchanges to follow these regional exchanges in permitting the sharing of commissions with nonmembers is discussed in text accompanying notes 72-78 *infra*.

¹⁰ As to the various factors affecting depth in the primary NYSE market, in the multiple exchange trading market in NYSE listed securities, and in the total trading market in NYSE listed securities by inclusion of the third market, see SEC, *Special Study* pt. 2, at 828-32.

¹¹ For a description of "reciprocity" in the mutual fund industry, see SEC, *Special Study* pt. 4, at 213-35.

tion.¹² This wrinkle in the antirebate rules has spawned a network of reciprocal business practices commonly referred to as the give-up or directed split.

Under this arrangement the mutual fund channels its portfolio securities transactions through a selected group of primary brokers who are NYSE members in a volume sufficient to permit these brokers to turn a profit and still give up sixty per cent of the total commission to other member firms. This sixty-forty split is the usual pattern in the industry. The fund managers direct the primary brokers to distribute these give-ups among those member firms who "push" the fund shares on the basis of the number of mutual fund shares each sells. This "kicker," now in the neighborhood of four per cent of the cost of the fund shares to the mutual fund investor, when added to the customary broker-dealer commission of six per cent on the sale of fund shares has been perhaps the most potent factor in the enormous growth of many mutual funds. Because of the NYSE antirebate rule vis-à-vis nonmembers, the mutual fund must pay the full commission regardless of the size of the order or services obtained from the primary broker. The management company or sponsors of the fund regard these give-ups as Chinese money which they are entitled to use to induce the broker-dealer to sell the fund shares. The structure of the mutual fund as a nonintegrated operation is such, however, that an increase in the size of the fund beyond a certain size as a general rule does not confer any financial benefit upon the fund as such nor upon its shareholders;¹³ however, such sales do swell the compensation of the underwriter of the fund who customarily retains two per cent of the sales price of fund shares as his commission.

Furthermore, the growth of the fund also increases the annual fees of the investment adviser to the fund, since his services are normally measured by a percentage of gross assets. Thus, the absence of any provision in the commission rate structure permitting cash discounts on volume transactions encourages the investment adviser and the underwriter of the fund to direct the payment of substantial amounts of the fund's commission costs to broker-dealers in return for sales services.

¹² The rules for the give-up of commissions are found in NYSE constitution article XV, §§ 2, 8. CCH NYSE GUIDE ¶¶ 1702, 1708.

¹³ As an aftermath of the mutual fund litigation attacking the industry custom of paying the investment adviser a flat fee of $\frac{1}{2}$ of 1% of the average assets of the fund during the year, many management adviser's fees are now based on a sliding scale which may drop to $\frac{1}{4}$ of 1% of assets in excess of \$500,000,000. See JENNINGS & MARSH, SECURITIES REGULATION—CASES AND MATERIALS 954 (1963). As the fund increases, the pro rata cost of advisory services per share will decline slightly. Against this slight saving in adviser's fees must be weighed the possible savings in commissions which might accrue to the fund on portfolio transactions if the best execution were sought.

The adviser and the underwriter thereby derive indirect tangible benefits without a corresponding benefit to the fund or its shareholders.¹⁴

It has been widely assumed within the mutual fund industry that since the NYSE commission rate structure prohibits any reductions on commission costs to the fund and since attention is called to such reciprocal arrangements in the selling prospectus in general terms, the adviser and underwriter are free from liability. Under general fiduciary principles, however, the directors of the fund would seem to have a duty to effect portfolio transactions at the lowest commission cost to the fund rather than for their own private advantage.¹⁵ As we shall see, in the case of large block transactions this may mean bypassing the Exchange if securities may be traded more cheaply elsewhere. Furthermore, to the extent that mutual funds develop their own sales organizations and thus loosen their business ties with NYSE member firms, the allocation of portfolio brokerage business based on the sale of fund shares will tend to diminish. A number of large mutual funds have already developed their own sales organizations; and the view has been expressed to this writer that the wave of the future is for more funds to move in this direction.¹⁶

There are other developments taking place in the mutual fund industry which may change the method of marketing mutual fund securities. First, there is every indication that a number of industrial and mercantile corporations bent on diversification either contemplate moving into the profitable mutual fund field or have already done so.¹⁷ For example, in February 1963, Allstate Enterprises, Inc. (a subsidiary of

¹⁴ It would be possible for the fund to increase the compensation of securities dealers by the extra 4%, rather than through give-ups, if the fund received quantity discounts equivalent to the 60% brokerage give-ups. It is by no means clear, however, that the funds would do so if the investor could understand the true selling costs to the fund.

¹⁵ The "Guide to Business Standards," adopted by the Investment Company Institute states that portfolio transactions should be "effected in a manner which is in the best interests of the investment company and its shareholders."

¹⁶ An indication of the extent to which some managers of the large funds have developed their own sales organizations can be seen by the following figures: Investors Diversified Services, Inc., of Minneapolis, sponsor, investment adviser, and distributor of a \$4,000,000,000 group of five funds, including the nation's largest, Investors Mutual, has 3,400 salesmen; Hamilton Management Corporation of Denver, sponsor, manager, and distributor of the Hamilton Funds, Inc., with assets of \$250,000,000 has 8,000 salesmen, of whom 20% work full time; and Insurance Securities, Inc., of San Francisco, manager and sponsor of the \$1,000,000,000 Insurance Securities Trust Fund has 582 full-time salesmen. See Nuccio, *Mutuals Stress Self-Regulation*, N.Y. Times, June 10, 1963, p. 20, col. 1.

¹⁷ See Blodgett, *The Frisky Funds—More Companies Move into Mutual Fund Field as Industry's Sales Soar*, Wall Street Journal, Oct. 19, 1964, p. 1, col. 6. Mr. Blodgett reports that in recent years "a railroad, a New York bank, a giant retailing and mail-order concern, and several insurance companies have either bought control of a mutual fund management company or decided to set one up themselves." And see Vartan, *Spotlight—Managing of Funds Pays—Mutually*, N.Y. Times, July 18, 1965, § 3, p. 2, col. 3.

Sears, Roebuck & Co.) announced that it had plans in the future to sell mutual fund shares through Sears "over the retail counter," just as Allstate Fire and Casualty Insurance is now sold.¹⁸ At the present time, this plan appears to be on ice, possibly because Sears believes that the stock market may be near its peak for the present business cycle. J. C. Penney Co. recently announced that it had reached an understanding with Channing Financial Corp., a mutual fund management corporation which also controls insurance companies whose insurance agents sell mutual fund shares managed by Channing, to acquire Channing's stock in exchange for J. C. Penney Co. stock. Although negotiations between the two companies were later terminated by mutual consent, Penney stated that it is still interested in the financial services field.¹⁹ It may be anticipated, therefore, that eventually one or more of the retail chains will either acquire a mutual fund management company or establish their own funds.

In the industrial arena, in 1964, Gates Rubber Co., a tire manufacturing company, bought control of Financial Programs, Inc., a mutual fund management company.²⁰ Similarly, in March 1964 International Telephone and Telegraph Corporation acquired ninety-four per cent of the voting stock and nine per cent of the nonvoting stock of Hamilton Management Corporation of Denver.²¹ It has since made an offer to the outside shareholders to buy Hamilton Management Corporation's assets through an exchange of I.T.&T. stock for the outstanding Hamilton voting and nonvoting stock. The ultimate objective is for I.T.&T. Management Research Co., a subsidiary of the parent company, to assume Hamilton Management Corporation's investment advisory contract with Hamilton Funds, Inc., a mutual fund with assets in excess of 250 million dollars. Inasmuch as I.T.&T. controls at least two insurance companies, it would seem possible for I.T.&T. to consider the desirability of combining the sale of life insurance with the sale of mutual funds through the use of a captive sales force. In this connection, it is significant that Hamilton Management Corporation maintains a captive sales organization of upward of 8,000 salesmen.

¹⁸ Wall Street Journal, Nov. 18, 1963, p. 5, col. 2; N.Y. Times, Sept. 5, 1964, p. 23, col. 3; see Blodgett, *supra* note 17.

¹⁹ See 37 MOODY'S INDUSTRIALS 2661 (No. 21, July 30, 1965); *id.* at 2148 (No. 48, Oct. 29, 1965); Wall Street Journal, Oct. 28, 1965, p. 2, col. 5.

²⁰ Blodgett, *supra* note 17.

²¹ 37 MOODY'S INDUSTRIALS 2513 (No. 27, Aug. 20, 1965). Prior to World War II I.T.&T. engaged primarily in the conduct of a communications business and in the manufacture of communications equipment. In the post-war period the company has branched out into the manufacture of a wide range of products. In addition to its proposed venture into the mutual fund management field, it has also entered the fields of consumer financing and insurance by means of corporate acquisitions of established concerns. See Penn, *The World of ITT*, Wall Street Journal, Oct. 28, 1965, p. 1, col. 6.

A somewhat similar move has been made by Fireman's Fund American Insurance companies of San Francisco. This insurance group has recently announced that it proposes to change its status to that of a holding company with a view to diversifying its business. Under California law, insurance companies are barred from having more than a thirty per cent ownership in a noninsurance enterprise. Under the proposal, the parent company would convert its various insurance company concerns into wholly owned subsidiaries of a holding corporation. The parent company would then merge with North American Investment Corporation, the management company of the San Francisco-based Commonwealth group of mutual funds.²² Again, it was reasonable to assume, as some newspapers did,²³ that the long-range goal of Fireman's Fund would be to package sales of Fireman's Fund Insurance and Commonwealth Mutual Funds. At the present time, however, neither organization has its own captive sales force, relying rather on the use of independent insurance agents or securities dealers, respectively. Nevertheless, the Fireman's Fund management has recently squelched such speculations by taking pains to dispel any thought that, if the merger is consummated, there will be a drastic change in sales policies. As to these rumors, Fred H. Merrill, President of Fireman's Fund, stated: "Fireman's Fund has no present intention of changing the investment or management policies of the Commonwealth funds or their relations with dealers and distributors"²⁴ The purpose of the merger is said to be primarily for investment, as the acquisition would add an income producing asset to the company's portfolio.²⁵ It was noted that there might also be some future advantage derived through combining the investment-analysis staffs of the mutual fund management company and the insurance group.²⁶

Certain banks are also endeavoring to enter the field by establishing what would amount to no-load mutual funds.²⁷ The First National City Bank of New York has made formal application to the Securities and

²² San Francisco Chronicle, Sept. 2, 1965, p. 53, col. 2; Wall Street Journal, Sept. 3, 1965, p. 10, col. 1; San Francisco Chronicle, Sept. 3, 1965, p. 48, col. 5; N.Y. Times, Sept. 10, 1965, p. 45, col. 7; Wall Street Journal, Sept. 10, 1965, p. 8, col. 1.

²³ E.g., San Francisco Chronicle, Sept. 2, 1965, p. 53, col. 2.

²⁴ Wall Street Journal, Sept. 3, 1965, p. 10, col. 1.

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ The no-load mutual funds employ no salesmen, thereby dispensing with the normal 8½% sales charge to fund investors; sales are made through various means of direct advertising, subject to strict regulation. The managers of no-load funds thus forego the approximately 2½% underwriting commission, but retain the investment adviser fee and, if NYSE members, receive brokerage commissions on portfolio transactions. As a result of these limitations, the no-loads have remained small, while the load funds have enjoyed an enormous growth. See *Personal Investing—Life Among the No-Loads*, Fortune, Oct., 1965, p. 86.

Exchange Commission to establish a "collective investment fund," requiring a minimum initial investment from any individual of 10,000 dollars and later investments, if any, of at least 1,000 dollars each. In order to manage such a mutual fund, the bank must obtain certain technical exemptions from the Investment Company Act of 1940.²⁸

At the same time, the mutual fund industry is undergoing other structural changes. As a matter of tradition, mutual fund management companies have been closely held business units controlled by the sponsors of the fund. In the past several years, however, in the case of more than twenty fund management companies, the control group has "bailed out" by making a public offering of shares.²⁹ Illustrative of this trend is the recent successful public offering by Dreyfus & Co., a NYSE member firm, of 2,246,550 shares in Dreyfus Corp., a Dreyfus & Co., subsidiary. Dreyfus & Co. took over the management of an existing fund in 1951 when the fund had only about 500,000 dollars of net assets. The fund, now called Dreyfus Fund, with the well-known Dreyfus lion as its symbol, in little over a decade has grown to 1,121,341,000 dollars of net assets having in excess of 300,000 stockholders, thus climbing in size to one of the top ten mutual funds. The offering price of twenty dollars a share yielded a harvest of 41,841,993 dollars for the selling shareholders, after deducting underwriting costs. Despite the public offering, the selling stockholders still retain a stock interest of about twelve per cent.³⁰

These developments foreshadow the dramatic changes now taking place inside and outside the mutual fund industry. They may be summarized as including: (1) the entry of nonfinancial corporations into the mutual fund management field; (2) the entry of major banking and other financial institutions into competition with the load funds through the establishment of no-load funds; (3) the possible expansion of no-load funds at the expense of the load funds;³¹ (4) the institutionalizing of mutual fund management companies through their conversion from closely held, to publicly held, companies; and (5) an increasing use of captive sales organizations by mutual fund management companies who heretofore have marketed their shares through securities dealers.

²⁸ N.Y. Times, Aug. 26, 1965, p. 45, col. 5. Among others, City Bank has requested an exemption from § 10(c) which forbids a registered investment company from having a majority of its board of directors consisting of persons who are officers or directors of any one bank. The Investment Company Institute, The National Association of Securities Dealers, Inc. and the Association of Mutual Fund Plan Sponsors, Inc., have gone on record with the SEC in opposition to the City Bank plan. Wall Street Journal, Sept. 22, 1965, p. 13, col. 1; *id.* Oct. 12, 1965, p. 10, col. 2; see N.Y. Times, Aug. 27, 1965, p. 36, col. 3.

²⁹ Wall Street Journal, Oct. 6, 1965, p. 7, col. 1.

³⁰ The Dreyfus Corporation Prospectus, Oct. 27, 1965, p. 19; Wall Street Journal, *supra* note 29.

³¹ *Personal Investing—Life Among the No-Loads*, Fortune, Oct., 1965, p. 86.

To the extent that mutual fund management companies either develop their own captive sales organizations or use NYSE nonmember firms, and thereby become independent of NYSE member firms for the sale of fund shares, the managers of the funds can be expected to look for other ways of effecting savings in commission costs. Likewise, institutional investors generally would be expected to seek savings in commission costs on portfolio transactions.

In the meantime, however, as in the case of nonmember professionals, the antirebate provisions of the NYSE commission rules may be evaded by mutual fund organizations through various special arrangements. In addition to some of those already mentioned, other valuable services include elaborate analytical and statistical services, investment advisory and management services, and the special and costly task of pricing the fund's entire portfolio and computing asset values several times each day.

In view of the various indirect methods of undermining the commission rate fortress, many portfolio managers for institutional investors find it difficult to understand why they cannot get a direct reduction in commissions on volume transactions. The result has been a significant growth in off-board transactions in NYSE listed securities—the so-called third market.

C. The Third Market

There have always been certain respected and well-capitalized non-member securities dealers who made markets in securities in which institutional investors were interested. At first they dealt in corporate bonds and preferred stocks. As institutional investors began to shift an increasing amount of their funds from fixed-yield securities to common stocks, however, these dealers followed the investment trends of their clients and began to make markets in NYSE common stocks. Sandwiched in between the exchange markets and the over-the-counter markets for unlisted securities, the SEC Special Study has dubbed this the "third market."³² This market is conducted by securities dealers who are not members of any exchange and therefore are free of exchange restrictions, including the rules against off-board trading and minimum commissions. Although the SEC Special Study found that more than four hundred non-member houses were active in the third market, six firms presently occupy dominant positions. They are American Securities Corporation; the First

³² For the origin and function of the third market, see Weeden, *The Third Market*, DUKE UNIVERSITY SCHOOL OF LAW CONFERENCE ON SECURITIES REGULATION 171-77 (Mundheim ed. 1965); Hillery, *Stocks at 'Discount'*, Wall Street Journal, Jan. 15, 1965, p. 1, col. 6; Phalon, *View of 'Third Market'*, N.Y. Times, Sept. 7, 1964, p. 23, col. 4; Vartan, *A Big-Board Splinter—Exchange Troubled by Growth in Sale of Listed Securities Over the Counter*, N.Y. Times, June 24, 1964, p. 49, col. 6; SEC, *Special Study* pt. 2, at 870-911.

Boston Corporation (whose shares are traded over the counter); New York Hanseatic Corp.; J. S. Strauss & Co.; Weeden & Co., Inc.; and Kipnis & Co.³³

The third market operates in this fashion: Suppose General Motors closed yesterday on the Big Board at 94 $\frac{3}{8}$. The NYSE commission rate on one hundred shares at this price is 48.44 dollars. A market maker may quote a price of 94 bid and 94 $\frac{1}{2}$ ask. If an institutional investor buys one hundred shares from the market maker at 94 $\frac{1}{2}$ it would pay a net price of 9,450 dollars, whereas if it bought on the Exchange the cost would be 9,437.50 dollars, plus a commission of 48.44 dollars, or a total price of 9,485.94 dollars. The saving would thus be 35.94 dollars per round lot or 359.40 dollars per thousand shares. On the other hand, if the institutional investor sold one hundred General Motors shares on the Exchange at 94 $\frac{3}{8}$, it would net 9,389.06 dollars as against 9,400 dollars if it sold to the market maker. Thus, the portfolio manager can effect a saving of 10.94 dollars per round lot by going through the third market.

There are, of course, reasons other than commission savings for using the third market; these include the ability to conduct private negotiations directly and obtain a firm price on a fixed quantity without the necessity of dealing through a broker in the auction market.

The third market dealers make their profit on the spread between the sales and purchase prices.³⁴ Although the Exchange has developed a number of special methods for handling large block transactions, these methods do not as a rule result in a savings in commissions. For this reason they have not achieved their purpose in forestalling the growth of the third market. Accordingly, mutual funds, banks, insurance companies, or pension funds are increasingly attracted by the savings that may be effected by trading in the third market.³⁵

³³ See Vartan, N.Y. Times, Aug. 7, 1963, p. 41, col. 7. It seems generally agreed that Weeden & Co. does the largest volume of third market business. Blyth & Co., Inc., a large investment banking firm, recently withdrew from the third market upon becoming a member of NYSE. The reason given for the switch was that the firm could "make more money being a member of the exchange than remaining a nonmember." It is also possible that Blyth & Co.'s ties with member firms in its capacity as a major managing underwriter, were loosened by its activities in the third market.

³⁴ The NYSE contends that these third market operators are getting a "free ride" by using the NYSE ticker service; they obtain the benefits of the exchange system without submitting to exchange controls. However, these nonmember firms are registered broker-dealers, subject to regulation under § 15 of the Securities Exchange Act of 1934; they are also members of the National Association of Securities Dealers. The basic question appears to be as to how far the NYSE's monopoly of trading in listed securities should extend by way of limiting competition from nonmember firms who trade off-board in listed securities.

³⁵ See Vartan, *supra* note 32. Under rule 17a-3, which became effective on January 4, 1965, the SEC has begun to collect statistical data on the volume of transactions in the

These third market operators provide a mechanism by which institutional investors and nonmember broker-dealers may now bypass the Exchange and escape the NYSE antirebate provisions, for these market makers offer price discounts off of NYSE quotations in a wide range of NYSE listed common stocks. In other cases, third market operations may simply involve a negotiated trade between institutional investors in which a nonmember firm acts as broker at a reduced commission.³⁶

II

LEGAL AND NON-LEGAL ATTACKS ON THE EXCHANGE AND ITS RATE STRUCTURE

A. Legal Attacks

Silver v. New York Stock Exchange,³⁷ decided by the Supreme Court in 1963, produced the first crack in the wall protecting the Exchange from competition from nonmembers. The Court there held that the self-regulatory duties imposed on the NYSE by the Securities Exchange Act of 1934 did not exempt the Exchange from the antitrust laws. Silver, a nonmember broker-dealer, had applied to the NYSE for direct wire telephone connections with a member firm. Temporary approval was granted and the connections established. Later, the Exchange, representing the collective action of the membership, ordered the member firm to terminate the connections, which it was compelled to do under an Exchange rule on file with the SEC. The Court found nothing in the self-regulatory scheme built into the Exchange Act, in its application to the particular facts, "which performs the antitrust function of insuring that an exchange will not in some cases apply its rules so as to do injury to competition which cannot be justified as furthering legitimate self-regulative ends."³⁸ It held that the termination of wire connections without explanation of the basis of its action, and without notice and a hearing, if requested, resulted in a group boycott which violated the antitrust laws.

third market. For the period January-March, 1965, the ratio of third market sales to total NYSE sales was 3.1% of shares traded and 4.1% in dollar value. SEC Statistical Bulletin, June, 1965, pp. 9-11. The ratio of third market volume to NYSE volume in 75 selected stocks, however, was 10.6%. If one considers that institutional trading accounts for approximately 25% of the total turnover, the competitive significance of the third market in the area of institutional investment is obvious.

³⁶ Some institutional investors have recently begun on a small scale to bypass brokers and to swap blocks of stocks directly, thereby giving birth to the Fourth Market. See Silberman, *Bypassing Brokers—Institutional Investors Begin Trading Stocks Directly Among Selves*, Wall Street Journal, Jan. 11, 1965, p. 1, col. 1.

³⁷ 373 U.S. 341 (1963); see Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW AND CONTEMP. PROB. 663, 668, 687 (1964).

³⁸ 373 U.S. at 358 (Goldberg, J.).

The *Silver* case was important to the third market, for the electronic quotation mechanism leased by the Exchange does not make available to nonmembers the bids and asks on the floor of the Exchange, although such information is immediately available to members merely by punching a key. With private wire connections, however, bid and ask quotations may be procured by the flip of a switch which connects the third market dealer by private wire with a member firm. Without this market information, the third market dealer would be compelled to fly blind, relying solely on the ticker service which reports actual sales only. After *Silver*, it was not inconceivable that the anticompetitive conduct of the Exchange such as that built into the commission rate structure (which is highly discriminatory to nonmembers) may give rise to injunction and treble damages actions under the Sherman Act.

The outer limits of the holding in *Silver* are by no means clear. It is to be noted that the Securities and Exchange Act of 1934 contemplates that registered exchanges may set brokerage commission rates, at least for transactions over the exchange. Thus, section 19(b)³⁹ of the Exchange Act empowers the Securities and Exchange Commission to step in and order changes in a registered exchange's rules and practices "when necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange" in respect of such matters as "the fixing of reasonable rates of commissions." It is possible, of course, that the Act only envisages the fixing of maximum, rather than minimum, commission rates. Moreover, it is arguable that the authorization of the Exchange to set rates, subject to the supervision of the SEC, relates solely to transactions on the floor of the Exchange and not to off-board transactions.

The Securities and Exchange Commission has itself imposed some limits upon efforts of the NYSE to control the activities of member firms with respect to transactions in securities listed on the NYSE when conducted off the floor of the exchange. Indeed, the single occasion in which the Commission exercised its section 19(b) powers occurred in 1941 when the NYSE sought to reactivate a rule prohibiting a member firm from acting as an odd-lot dealer or specialist or otherwise publicly dealing for its own account on another exchange in securities listed on the NYSE. In a section 19(b) proceeding, the Commission found that enforcement of the prohibition against member firms' dealings on any of the regional exchanges of which it was a member would have a disrupting effect on the volume of trading and the economic health of regional exchanges and was

³⁹ 48 Stat. 881 (1934), 15 U.S.C. § 78s(b) (1964).

likely to result in irreparable damage to these exchanges.⁴⁰ The Commission concluded:

It seems to us, therefore, that the Rule would operate as an unreasonable and unjustified restraint upon interstate commerce and that enforcement of the Rule would violate one of the basic purposes of regulation under the Act, a purpose which is closely related to the public policy regarding unreasonable restraints and the maintenance of fair competition as declared by Congress in the Sherman Act, the Clayton Act, and the Federal Trade Commission Act.⁴¹

Accordingly, the Commission ordered a change in the predecessor to section 8 of article XIV of the NYSE constitution⁴² so that, although the NYSE is permitted to regulate member firms in dealing publicly outside the exchange as a general rule, the Exchange is forbidden to prohibit one of its member firms from acting as an odd-lot dealer or specialist or otherwise publicly dealing for its own account in NYSE listed securities on another exchange, located outside of New York City. This proceeding seems also to have ended any efforts of the NYSE to prevent its members from becoming a member of a regional exchange and exercising all of the privileges of such exchange, including privileges relating to NYSE securities having a dual listing.

The question still remains, however, whether the NYSE commission rate structure as applied to institutional investors and particularly to mutual funds may be challenged by a treble damage action in an antitrust proceeding or whether, by virtue of the regulative powers vested in the Commission under section 19(b) of the Exchange Act with respect to the fixing of "reasonable rates of commission" in order "to insure fair dealings in securities traded in upon such exchange," the Commission has primary jurisdiction, to the exclusion of the antitrust court.

Since the *Silver* case, the Exchange anticompetitive practices have come under fire from several directions. In October 1963 the Thill Securities Corporation, a nonmember broker-dealer based in Wisconsin, filed an antitrust action against the Exchange attacking the antirebate rules prohibiting member firms from sharing commissions with nonmember firms who bring business to the Exchange through a member firm.⁴³ The charge is made that the limitation of Exchange memberships to 1,366

⁴⁰ In the Matter of the Rules of the New York Stock Exchange, 10 S.E.C. 270, 281, 283, 284 (1941); see SEC, TRADING & EXCHANGE DIV., REPORT ON THE PROBLEM OF MULTIPLE TRADING ON SECURITY EXCHANGES (1940).

⁴¹ *Id.* at 287.

⁴² CCH NYSE GUIDE ¶ 1658.

⁴³ Thill Securities Corp. v. New York Stock Exchange, Civil No. 63-C-264, E.D. Wis., Oct. 18, 1963.

and the high cost of seats on the Exchange when they become available effectively foreclose nonmembers from dealing on the floor of the Exchange and force them to execute customers' orders through NYSE members without compensation. Relief by way of injunction and treble damages is sought. Although the suit is reported to be quiescent,⁴⁴ other reports are to the effect that any delay is the result of a crowded calendar in that district.

The plaintiff in *Kaplan v. Lehman Brothers*, a suit in the federal district court in Chicago, is a shareholder in four mutual funds who is proceeding derivatively on behalf of the funds against the fund advisers and managers, the NYSE member firms who serve as primary brokers in handling the funds' portfolio transactions, other NYSE member firms who participate in give-ups on these transactions, and the NYSE.⁴⁵

The complaint proceeds on two theories: (1) The NYSE has constructed a minimum commission rate structure binding all member firms in their dealings with nonmembers; the defendant funds in each case are dominated by brokerage firms who are member organizations of the NYSE; these member organizations of the NYSE have, through their membership in the NYSE, acted in concert and pledged themselves to adhere to the minimum commission rate structure; the defendant funds through their directors and investment advisers are under a continuing fiduciary duty to stockholders of the funds to execute portfolio transactions on behalf of the funds on a "best execution" basis, that is, purchasing stock at the lowest price obtainable and selling stock at the highest price obtainable, including commission charges; that had one or more member brokers of the NYSE offered reduced rates of commission on block transactions, directors of the funds and their investment advisers could have executed portfolio transactions of the funds at great savings in commissions. The complaint also alleges that the last increase in NYSE commission rates in 1959 entailed an 11½ per cent raise to which all members were compelled to adhere, even though numerous NYSE members openly opposed the raise; that the Exchange has proposed to raise the rates again, thus further adding to the commission costs of the funds and their shareholders. Plaintiff asks for a declaratory judgment that these various agreements are in restraint of trade and are void, and for an injunction and treble damages. (2) A cause of action is also attempted

⁴⁴ Shanahan, *Trust Suits Stir Wall St. Jitters*, N.Y. Times, Feb. 17, 1965, § 3, p. 1, col. 1.

⁴⁵ *Kaplan v. Lehman Bros.*, Civil No. 65-C-407, N.D. Ill., March 18, 1965. The action is brought on behalf of One William Street Fund, Energy Fund, the Dominick Fund, the Chemical Fund, and the Lehman Corporation. The defendants are Lehman Brothers; Goodbody & Co.; Dominick & Dominick; Paine, Webber, Jackson & Curtis; and the New York Stock Exchange. See N.Y. Times, March 25, 1965, p. 1, col. 2; Wall Street Journal, March 25, 1965, p. 10, col. 2.

to be stated under the Securities Exchange Act of 1934. That Act is said to impose on the defendants, consisting of the NYSE and the member firms, the duties to operate a fair and honest market, to engage in fair dealing and to comply with just and equitable principles of trade. These duties are alleged to have been violated by defendants insofar as such defendants have compelled the funds to pay noncompetitive, excessive, and unreasonable brokerage commissions on portfolio transactions.⁴⁶

*Pan American World Airways, Inc. v. United States*⁴⁷ has been cited for the proposition that the *Kaplan* suit should fail on the ground that the Securities Exchange Act of 1934 vests in the Securities and Exchange Commission primary jurisdiction over any complaints regarding the NYSE commission rate structure.⁴⁸ Thus, it is argued, the Commission's section 19(b) powers, after notice and hearing, to make changes in a registered exchange's commission rates, foreclose an antitrust court from inquiring into Exchange practices alleged to be in violation of the Sherman and Clayton Acts and to award treble damages for a violation.

The NYSE and four of the member firms named as defendants in the *Kaplan* suit have filed a motion to dismiss the action relying upon this doctrine of primary jurisdiction.⁴⁹ These defendants take the view that under the Exchange Act the NYSE "has a Federally mandated duty of self-regulation that includes the fixing of commission rates . . .".⁵⁰ Furthermore, the Securities and Exchange Commission's power under section 19(b) to review such rate-fixing activity is said to render the Exchange immune from antitrust attack in the courts. The defendants in the *Kaplan* suit contend that the *Silver* case is inapplicable to price fixing of commission rates by the Exchange.

The Supreme Court's opinions in this area cannot be said to have resolved this problem. The *Panagra* case⁵¹ was a civil suit brought by the United States charging violations by Pan American, W. R. Grace & Co., and Panagra of sections 1, 2, & 3 of the Sherman Act. The suit was brought by the Attorney General at the request of the Civil Aeronautics Board charging two restraints of trade: first, that Pan American and Grace, each of whom owned fifty per cent of the stock of Panagra, formed the latter under an agreement that Panagra would fly the air routes along

⁴⁶ As a result of the *Kaplan* suit, the Justice Department Antitrust Division instituted an investigation of the NYSE and other securities trading markets. Wall Street Journal, March 26, 1965, p. 3, col. 1.

⁴⁷ 371 U.S. 296 (1963).

⁴⁸ Bicks, *Antitrust and the New York Stock Exchange*, 21 BUS. LAW. 129, 151 (1965).

⁴⁹ Wall Street Journal, Oct. 18, 1965, p. 13, col. 1.

⁵⁰ Memorandum of New York Stock Exchange in Support of Defendants' Motion to Dismiss and for Summary Judgment, p. 9, *Kaplan v. Lehman Bros.*, Civil No. 65-C-407, N.D. Ill., March 18, 1965.

⁵¹ *Pan American World Airways, Inc. v. United States*, 371 U.S. 296 (1963).

the West Coast of South America free from Pan American competition and that Pan American would be free from competition of Panagra in other areas in South America; second, that Pan American and Grace had conspired to monopolize commerce between points in the United States and South America. When the matter reached the United States Supreme Court, the Court held that section 411 of the Federal Aviation Act,⁵² adopted in 1958, vested in the Civil Aeronautics Board primary jurisdiction to grant relief from the alleged violation of the antitrust laws.

Mr. Justice Douglas, speaking for a majority, noted that under section 411 of the 1958 Act, the Civil Aeronautics Board had jurisdiction over "unfair practices" and "unfair methods of competition" even though arising prior to 1938. Apart from its power under section 411, the Board was also given authority by sections 408 and 409 to pass upon consolidations, mergers, purchases, leases, operating contracts, acquisition of control of an air carrier, and interlocking relations. Under section 412, the Board was given jurisdiction over pooling and other like arrangements. Moreover, by virtue of section 414, any person affected by an order under sections 408, 409, and 412 is "relieved from the operations of the antitrust laws," including the Sherman Act. The narrow question presented by the *Panagra* case was whether government enforcement of antitrust policies in the air transportation field was to be vested in the Department of Justice or in the Civil Aeronautics Board, an independent regulatory agency created by Congress with powers to act in this precise area. In holding that the CAB rather than the Department of Justice had primary jurisdiction over governmental enforcement activities, the Court took pains to point out that the CAB was authorized to grant the remedy sought by the government. On the other hand, the Court observed that if a remedy were sought in a civil antitrust suit "that was not available in a section 411 proceeding before the Civil Aeronautics Board," a different problem would be presented.⁵³

Later cases in the lower federal courts have thrown further light on the problem of primary jurisdiction as it relates to the issues presented in the *Kaplan* suit.

In *Trans World Airlines, Inc. v. Hughes*,⁵⁴ plaintiff airline (TWA) alleged that defendant Hughes Tool Company (Tool Co.) had violated the antitrust laws through Tool Co.'s domination of TWA resulting from a seventy-eight per cent ownership of TWA's common stock and control of

⁵² 72 Stat. 731 (1958), as amended, 49 U.S.C. § 1301 (1964).

⁵³ 371 U.S. at 313. Mr. Justice Brennan, with whom Chief Justice Warren concurred, dissented on the basis that the Federal Aviation Act did not deprive an antitrust court of jurisdiction to hear and determine the question whether the agreements and arrangements between Pan American and Grace violated the antitrust laws.

⁵⁴ 332 F.2d 602 (2d Cir. 1964).

a majority of its directors. Through this domination, it was claimed that Tool Co. forced TWA to purchase jet aircraft from General Dynamics Corporation (Convair), with whom Tool Co. had working arrangements instead of from Boeing Corporation, a competing manufacturer. As a consequence, TWA was not able to convert from propeller planes to jet aircraft as quickly as its competitors, to its financial injury. Tool Co. was also alleged to have refused to allow TWA to undertake equity financing, except on the condition that Tool Co. be permitted to increase its equity position in TWA. TWA was thereby forced to finance the purchase of aircraft solely through debt financing. TWA sought injunctive relief and treble money damages for these supposed antitrust violations.

Relying upon the *Panagra* case, the defendant asserted that the CAB possessed primary jurisdiction over these matters; that in fact the CAB in the exercise of its regulatory powers, had approved various transactions between Tool Co. and TWA and that such approval conferred immunity upon the defendants from the operation of the antitrust laws. The federal district court held that nothing in the Federal Aviation Act precluded an antitrust court from assuming jurisdiction of the complaint; that the CAB's approval of various transactions between TWA and Tool Co. did not confer antitrust immunity; and granted a judgment for plaintiffs.

On appeal, the Court of Appeals affirmed. The court read the *Panagra* case as dealing with such specific problems as the limitation of air routes, the division of territories, and the relation of common carriers to air carriers. These matters were " 'basic to [the] . . . regulatory scheme' of the Federal Aviation Act" and were " 'the precise ingredients of the Board's authority.' " ⁵⁵ The relationship between the allegedly unlawful activities in the *Panagra* case and the scope of the Board's powers to deal with such activities was direct. On the other hand, TWA's complaint alleged "transactions which are unrelated to any specific function of the CAB." ⁵⁶ Although acquisition of control over an air carrier required approval of the CAB, the focus of the Board's powers in this sphere was on the acquisition itself rather than upon the broad range of activities in which the controlling person might thereafter engage. Under the Federal Aviation Act "the antitrust problems entrusted . . . to the Board 'encompass only a fraction of the total' "; ⁵⁷ and the activity of which TWA complained fell outside of those antitrust problems as to which the CAB had been given exclusive jurisdiction.

The court of appeals also stressed the fact that the Federal Aviation Act itself specifically provides that nothing therein "shall in any way

⁵⁵ *Id.* at 607.

⁵⁶ *Id.* at 608.

⁵⁷ *Id.* at 609.

abridge or alter the remedies now existing at common law or by statute, but the provisions . . . [of the Act] are in addition to such remedies."⁵⁸ Furthermore, under the Act, the CAB was without power to award money damages, which under the antitrust laws might be trebled. Thus, it was unlikely that Congress intended to remove the jurisdiction of an antitrust court to hear the larger antitrust issues involved in the TWA case and enforce the private antitrust remedies.⁵⁹

In the *Kaplan* suit, as in the *TWA* case, far more is in issue than the reasonableness of the NYSE minimum commission rates as such. A fundamental attack is made upon the mutual fund industry structure in its relation to the NYSE and member firms who sponsor mutual funds. There is little evidence to indicate that the Securities and Exchange Commission, in exercising its power to review the NYSE commission rates over the years, has weighed the impact of the various reciprocal arrangements prevalent in the mutual fund industry and the brokerage fraternity which rest upon the commission rate edifice. While the Commission might have jurisdiction to attack this problem, so far it has not done so. It is not clear, however, that jurisdiction of an antitrust court over the antitrust charges in the *Kaplan* suit would hinge upon failure of the Commission to investigate the NYSE commission rate structure as it applies to the mutual fund industry. In any event, however, the *Kaplan* court, on the basis of the *TWA* case, could hold that the powers to enforce antitrust policies entrusted to the Commission by the Exchange Act encompasses only a fraction of the total antitrust problems, that the Commission lacks power to compensate injured parties for damages incurred arising from such practices, and that any relief which it might grant would be prospective only. It seems clear, therefore, that total reliance upon the *Panagra* case as giving the NYSE and the other defendants in the *Kaplan* case antitrust immunity under the Exchange Act must be regarded as an oversimplification of the problem.

Another rash of suits eschew antitrust concepts and make a more direct attack upon the mutual fund industry practice of reciprocity.⁶⁰ These too are derivative suits brought by shareholders of various funds against the officers, directors, investment adviser and broker of each fund. They allege that the defendants, in violation of their fiduciary duties, channel purchases and sales of NYSE listed securities through NYSE member firms so as to divert brokerage commissions at fixed rates to the member firms, rather than seeking the best execution in the third

⁵⁸ *Ibid.* The Securities Exchange Act § 28(a), 48 Stat. 903 (1934), 15 U.S.C. § 78bb(a) (1964), similarly preserves existing legal and equitable remedies.

⁵⁹ To the same general effect, see *Wills v. Trans-World Airlines, Inc.*, 200 F. Supp. 360 (S.D. Cal. 1961); Jaffe, *Primary Jurisdiction*, 77 HARV. L. REV. 1037, 1054-70 (1964).

⁶⁰ Wall Street Journal, May 18, 1965, p. 6, col. 2.

market. These practices are claimed to violate sections 10(b), 27 and 29 of the Exchange Act; sections 15, 20, 34, 36, 37, 44 and 47 of the Investment Company Act and sections 206, 214, 215 and 217 of the Investment Advisers Act.⁶¹ These suits are now at the discovery stage. The plaintiffs would seem to have standing to sue and the court to have jurisdiction over the subject matter of the complaints.⁶²

These suits based upon the failure of the investment managers to shop the third market thus make an indirect attack upon the NYSE rule 394 which, with the exceptions previously noted, in effect requires a member firm to execute brokerage transactions in listed securities on the floor of the Exchange rather than seeking a better execution elsewhere. In the case of member firms who serve as investment advisers and primary brokers, their fiduciary duty to obtain the best execution for the fund comes in direct conflict with the Exchange rule. While an institutional investor who is handling its own investments may deal as it pleases, one who acts in a fiduciary capacity handling other peoples' money has a duty to seek the market which is most advantageous to the fund, rather than using a market that is to its own private advantage. Thus, these suits strike at the very heart of the mutual fund industry structure which entails the contracting out to affiliated companies of the various services which in ordinary industry would be performed by managers employed by the firm itself.⁶³

The listing of Chase Manhattan Bank stock on the Big Board set off further fireworks in the antitrust arena.⁶⁴ Most bank stocks, including Chase Manhattan shares, have traditionally been traded over the counter. A market in Chase Manhattan stock was made by some sixteen firms, evenly divided between NYSE member firms and nonmember firms.⁶⁵ With the advent of the Securities Acts Amendments of 1964, Chase Manhattan decided to list its common shares on the Exchange to "provide a broader market."⁶⁶ M. A. Shapiro & Co., Inc., a dealer in bank stocks,

⁶¹ At least four suits have been filed in the Southern District of New York: *Cohen v. Meyer* (The Lazard Fund); *Lesser v. Samuel* (Energy Fund); *Rosenblatt v. Lehman* (One William Street Fund); and *Waxman v. Youngman* (National Investors Corporation). Suits have also been filed against other funds.

⁶² See *Levitt v. Johnson*, 222 F. Supp. 805 (D. Mass. 1963), *rev'd on other grounds*, 334 F.2d 815 (1st Cir. 1964).

⁶³ Note, *The Mutual Fund and Its Management Company: An Analysis of Business Incest*, 71 YALE L.J. 137 (1961).

⁶⁴ For the story of the capture of the Chase listing by the NYSE, see N.Y. Times, Feb. 17, 1965, p. 61, col. 4; N.Y. Times, Feb. 27, 1965, p. 29, col. 7; Wall Street Journal, March 15, 1965, p. 24, col. 1; N.Y. Times, March 17, 1965, p. 65, col. 5.

⁶⁵ Bank Stock Quarterly, Sept. 1964, p. 16 (published by M. A. Schapiro & Co.).

⁶⁶ Statement of George Champion, Chairman of the Chase Board, N.Y. Times, Feb. 17, 1965, p. 61, col. 4.

including Chase Manhattan stock, while not objecting to listing of the stock, implored the NYSE, in newspaper advertisements, to exempt the stock from rule 394.⁶⁷ Instead, the Exchange applied the restrictions of the rule to the Chase Manhattan stock. The effect was to force NYSE members to discontinue dealings in Chase Manhattan stock with M. A. Shapiro & Co. and with other nonmember firms. Thus, when a fund or other institutional investor places an order for Chase Manhattan stock with a member firm, that firm is forbidden to seek a better execution off the floor of the Exchange. Thus, by group boycott, member firms are forbidden to deal with nonmembers in Chase Manhattan stock, as they customarily did prior to NYSE listings, even though a better price might be obtained for their customers off the Exchange.⁶⁸ As the controversy warmed up the SEC ordered its staff to study "rule 394 of the New York Stock Exchange and rules of other exchanges that 'restrict the ability of members of such exchanges to execute off-board transactions in securities admitted to trading on such exchanges.'"⁶⁹ The NYSE had already appointed a Special Committee on Costs and Revenues to make its own study of rule 394 and other restrictive practices and, as a result of this study, the Exchange has taken a posture which essentially supports the *status quo*.⁷⁰ Even earlier, the Exchange had taken under consideration a package proposal to increase commission rates by 3.5 per cent and impose a mandatory fee for special services which are now provided without charge.⁷¹

⁶⁷ See N.Y. Herald Tribune, March 16, 1965, p. 35, cols. 5-8.

⁶⁸ For the position of M. A. Schapiro & Co., see the firm's Bank Stock Quarterly, Sept. 1964, p. 15; *id.*, Dec. 1964, p. 17; *id.*, March 1965, p. 14; Letter from Morris Schapiro to Honorable Wright Patman, July 2, 1965. See also Vartan, N.Y. Times, Feb. 17, 1965, p. 61, col. 4.

⁶⁹ Wall Street Journal, March 3, 1965, p. 6, col. 3.

⁷⁰ See Memorandum of G. Keith Funston, NYSE President, to Members reporting the tentative recommendations of Cost and Revenue Committee, December 29, 1964; NYSE News Release, Dec. 30, 1964, reporting the tentative conclusions made by Committee on Cost and Revenue to the Board of Governors; Memorandum of G. Keith Funston to Members concerning additional recommendations of Cost and Revenue Committee, Jan. 12, 1965; N.Y. Times, Jan. 14, 1965, p. 49, col. 6; Wall Street Journal, Jan. 14, 1965, p. 4, col. 2.

⁷¹ For the proposal to impose a mandatory fee for special services, see Wall Street Journal, Oct. 12, 1964, p. 3, col. 2; N.Y. Times, Oct. 13, 1964, p. 59, col. 6 (Merrill Lynch opposes compulsory service charges for securities customers); Wall Street Journal, Oct. 13, 1964, p. 28, col. 2; N.Y. Times, Nov. 19, 1964, p. 57, col. 6.

As to the boosting of Commission rates across the board, see Wall Street Journal, Dec. 31, 1964, p. 3, col. 1; N.Y. Times, Dec. 31, 1964, p. 1, col. 2; Vartan, *Hard Look at Commissions*, N.Y. Times, Jan. 11, 1965, p. 93, col. 7.

The SEC Staff was reported to be critical of the proposal for higher brokerage fees and mandatory service charges. Wall Street Journal, Jan. 22, 1965, p. 1, col. 6; it commenced its own study of industry costs and profits from securities commission business. Wall Street Journal, Feb. 12, 1965, p. 9, col. 3.

B. *Non-legal Attacks*

While these efforts to storm the NYSE commission rate fortress have been underway, two developments have occurred on the regional exchanges that have impelled the NYSE to make a radical re-examination of its position. The first of these innovations might be dubbed the "double reverse" to distinguish it from the "end run" previously described.

1. *The "Double Reverse"*

For some time prior to 1964, the Detroit Stock Exchange (DSE) had permitted its members to split commissions with any nonmember of that exchange who was a member of the National Association of Securities Dealers (NASD) or of another exchange where the rules of the other exchange permitted reciprocal arrangements. The nonmember in such cases could have his customer's order executed on the floor of the DSE by a member at not less than sixty per cent of the regular minimum commission rate.⁷² Furthermore, on transactions executed by a member firm on behalf of any bank (acting on its own account or as a fiduciary), any insurance company, or any registered investment company, the member firm may give up an amount up to forty per cent of the commission to any member of the NASD.⁷³

The Pacific Coast Stock Exchange (PCSE) had also moved in the same direction. Under current PCSE rules a member firm may execute orders for "approved nonmembers who are members of a national securities exchange, or a national securities association, or the Honolulu stock exchange, or who are engaged in the banking business in the United States" at seventy-five per cent of the regular minimum commission rates.⁷⁴ Member firms may also accept orders for execution from registered investment funds on a give-up basis: up to seventy per cent of the commission may be given up to members of the exchange while up to twenty-five per cent of the commission may be given up to approved nonmembers. Any member of a regional exchange, any member of the NASD, and any company doing a domestic banking business may gain approval by paying a nominal fee.⁷⁵

Apparently, in early 1964, a number of NYSE member firms, acting pursuant to the directions of mutual fund customers, began to divert transactions in NYSE listed securities to those regional exchanges that permitted the sharing of commissions with nonmember professionals.

⁷² See SEC, *Special Study* pt. 2, at 300; Detroit Stock Exchange Rules, ch. VII, § 9, as amended (July 12, 1965); see note 9 *supra*.

⁷³ *Ibid.*

⁷⁴ Pacific Coast Stock Exchange Rules, rule IV, § 2.

⁷⁵ *Id.*, rule IV, § 5.

Furthermore, as this article goes to press, three other major regional exchanges have either amended their rules to legitimize commission splitting with nonmembers or have requested the Securities and Exchange Commission for consent to do so. Only the Midwest and the Pittsburgh stock exchanges remain holdouts and they can reasonably be expected sooner or later to take similar action.⁷⁶

The effect of these rules changes by most of the major regional exchanges is to permit mutual funds to place orders on NYSE listed securities on these exchanges and arrange for the give-up of a portion of the commissions to any broker-dealer who is a member of the NASD, which encompasses most of the securities dealers of the country.⁷⁷ In order not to lose commission business which may thus be diverted to the regional exchanges, there has been a rush by NYSE members to acquire seats on those exchanges.⁷⁸ Thus, while give-ups on transactions executed on the Big Board must be confined to other NYSE member firms, if the transaction in NYSE listed securities is executed over one of the regional exchanges allowing the sharing of commissions with any nonmember who is a member of the NASD, almost any broker-dealer selling fund shares may participate in the brokerage give-ups. Accordingly, the double reverse enables the mutual fund to circumvent the NYSE antirebate rule to the extent necessary to compensate brokers.

2. *Stock Exchange Membership for Mutual Funds*

This innovation, however, failed to solve the problem for those mutual fund management companies which sell fund shares through captive sales organizations. It was not surprising, therefore, the early in 1965, Waddell & Reed, Inc., the management company for United Funds, Inc., based in

⁷⁶ The stampede apparently started in July 1965 when the Boston Stock Exchange proposed to revamp its rules so that members could participate in reciprocity from NYSE member firms and mutual funds on NYSE listed stocks having a dual listing on the Boston Stock Exchange, a practice theretofore forbidden. See N.Y. Times, July 18, 1965, § 3, p. 1, col. 2. In late September, the Exchange expanded its rule to permit the sharing of commissions with nonmembers who were members of the NASD. The Philadelphia-Baltimore-Washington Stock Exchange joined the parade in early November 1965 with the frank statement that the proposed change in its rule "is aimed at further stimulation of the execution of large block orders on the exchange by mutual funds." Wall Street Journal, Nov. 3, 1965, p. 10, col. 1. The Cincinnati Stock Exchange had acted previously. For a round-up of these events and their impact on the NYSE, particularly in volume trading by institutional investors, see Phalon, *Regional Exchanges Moving in on Big Board—From Boston to the Coast, Their Trading Is Mounting*, N.Y. Times, Nov. 7, 1965, § 3, p. 1, col. 3.

⁷⁷ On the composition of the broker-dealer community and the NASD, see SEC, *Special Study*, pt. 1, at 15-37.

⁷⁸ See Wall Street Journal, Aug. 13, 1965, p. 2, col. 3; *id.*, Aug. 20, 1965, p. 12, col. 6; Time, Sept. 3, 1965, p. 78, col. 2; Phalon, *supra* note 76. The Cincinnati Stock Exchange recently split its membership 3 for 1 to meet the demand for seats. Wall Street Journal, Oct. 6, 1965, p. 15, col. 2.

Kansas City, Missouri, organized a wholly-owned subsidiary, Kansas City Securities Corporation (KCSC), which applied for membership on the Pacific Coast Stock Exchange.⁷⁹ Waddell & Reed is a publicly held company with some 3300 shareholders that makes ninety per cent of its mutual fund sales through its own personnel and thus need not depend upon reciprocity to stock brokers selling its funds. The constitution of the NYSE prohibits membership to publicly held companies or their units, but the PCSE has no such barrier.⁸⁰ Waddell & Reed proposed to make a profit through its subsidiary, but also to pass a financial benefit to the United Funds by reducing the management and advisory fees paid to it equal to an agreed percentage of the profits earned by KCSC from brokerage commissions.⁸¹

After some backing and filling, the PCSE admitted KCSC to exchange membership subject to certain restrictions.⁸² Doubtless existing antitrust litigation against the NYSE and the threat of possible litigation against the PCSE were factors in the breakthrough to exchange membership for a mutual fund affiliate. Investors Diversified Services, Inc., a publicly owned company which manages five funds, including the nation's largest, immediately applied for and has been granted permission to become a member of the PCSE.⁸³ The Maginot Line has now been circumvented; these funds may now trade in NYSE listed stocks without having to pay a commission to a NYSE member firm.

III

THE ROLE OF THE SECURITIES AND EXCHANGE COMMISSION

One of the curious aspects of the current controversy has been the inactivity of the Securities and Exchange Commission. So long as the fortress seemed impregnable the New York Stock Exchange was not interested in receiving antitrust immunity in return for an extension of SEC review powers in the areas of rule-making, enforcement, and discipline.⁸⁴ On the other hand, although the SEC staff has been studying

⁷⁹ See Vartan, *Smoke Over the Pacific*, N.Y. Times, Jan. 9, 1965, p. 29, col. 6; *id.*, Jan. 5, 1965, p. 39, col. 7; *id.*, Jan. 12, 1965, p. 47, col. 5.

⁸⁰ NYSE CONST. art. IX, §§ 2, 7; CCH NYSE GUIDE ¶¶ 1401, 1407; Vartan, *Pacific Exchange Weighs Fund Role*, N.Y. Times, Jan. 5, 1965, p. 39, col. 7.

⁸¹ Vartan, *Waddell & Reed To Pass Saving of Broker Plan to United Funds*, N.Y. Times, Jan. 12, 1965, p. 47, col. 5.

⁸² Wall Street Journal, May 4, 1965, p. 4, col. 2.

⁸³ Wall Street Journal, May 22, 1965, p. 4, col. 3; *id.*, July 6, 1965, p. 4, col. 2. IDS has announced: "Anything we can save or earn by being a member of the Pacific Coast Stock Exchange will be passed on to our fund shareholders, probably in the form of lower management fees." S.F. Chronicle, Aug. 3, 1965, p. 52, col. 6.

⁸⁴ In late 1963, after *Silver*, the SEC reportedly asked the NYSE to consider legislation which would extend the Commission's supervisory powers over the exchange for specific

the problem, little or no information has reached the public as to what the Commission intends to do, if anything, about NYSE rule 394, the antirebate provisions, reciprocity, and the proposed commission rate raise, although the latter proposal seems to have been temporarily shelved by the Exchange. It is therefore extremely difficult to learn what is really going on behind the scenes at the Commission and at the Exchange.

On August 4, 1965, however, disclosure was made that Manuel F. Cohen, Chairman of the Securities and Exchange Commission, on July 30, 1965, wrote to Senator A. Willis Robertson, Chairman of the Senate Banking Committee, suggesting ("it was not an outright recommendation")⁸⁵ that legislation be enacted extending the Commission's supervisory powers over rule-making, enforcement, and discipline by the exchanges in return for specific statutory immunity from the antitrust laws.⁸⁶ Although the Department of Justice, Antitrust Division, has not declared its position, Donald C. Turner, the new Assistant Attorney General, stated that "he expected 'to work cooperatively with the commission on matters of mutual concern.'"⁸⁷

The SEC proposal to grant partial antitrust immunity to the exchanges may meet rather stiff opposition in Congress. Representative Emanuel Celler, Chairman of the House Judiciary Committee and its Antitrust Subcommittee, in a letter to Chairman Cohen of the SEC, has announced his "unalterable opposition" to the proposals.⁸⁸ On the Senate side, Senator Philip A. Hart, Chairman of the Senate Antitrust and Monopoly Investigating Committee has voiced similar views.⁸⁹ Chairman Cohen in responding to these letters has sought to allay criticism by assuring Senator Hart and Congressman Celler that the SEC would not seek to change the antitrust barriers in "such traditional areas as mergers, interlocking relationships of stock exchange members or concentration of economic power."⁹⁰ It is by no means clear, however, what the Commission's ultimate position will be on the antirebate rule, off-board transactions by exchange members, associate memberships, fee splitting with

antitrust exemption. Wall Street Journal, Aug. 4, 1965, p. 3, col. 2. At that time the Exchange was not interested.

⁸⁵ Shanahan, *Trust Immunity in Market Urged*, N.Y. Times, Aug. 4, 1965, p. 43, col. 4; Wall Street Journal, Aug. 4, 1965, p. 3, col. 2.

⁸⁶ *Ibid.* I made a similar proposal in May, 1964. Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW AND CONTEMP. PROB. 663, 689 (1964). After further study, I am somewhat more cautious; I believe that there are grave dangers in this approach unless the Commission assumes a more aggressive regulatory posture.

⁸⁷ Shanahan, *supra* note 85.

⁸⁸ Wall Street Journal, Aug. 19, 1965, p. 5, col. 3; N.Y. Times, Aug. 19, 1965, p. 37, col. 6.

⁸⁹ N.Y. Times, Sept. 8, 1965, p. 63, col. 3; Wall Street Journal, Sept. 8, 1965, p. 19, col. 2.

⁹⁰ Wall Street Journal, Oct. 12, 1965, p. 15, col. 1.

nonmember broker-dealers, the whole question of give-ups, and quantity discounts for institutional investors. Furthermore, the "primary jurisdiction" question now before an antitrust court in the *Kaplan* case is necessarily woven into the antitrust fabric which the SEC proposes to unravel. At this writing, Congress has adjourned without any action on the SEC's trial balloon.

In view of the importance of the Exchange to continued economic growth in this country and of the importance of maintaining free and open competition in the securities markets, legislation of the type proposed must be subjected to searching examination inside and outside the government and the securities industry.⁹¹ It is still too early to come to any definitive conclusions; however, I feel that it is possible to advance some tentative suggestions that must be considered in any effort to solve the problems now facing the securities industry.

IV

POSSIBLE CHANGES IN THE RATE STRUCTURE

It seems quite clear that the Exchange should not be allowed to shore up the commission rate structure so as to continue its anticompetitive practices at the expense of nonmember firms. The Exchange is a very important market place and should be strengthened and preserved; nevertheless, the mere listing of a stock on the Big Board should not create a trading monopoly for member firms. A number of modifications of current practices should be seriously considered.

A. The European Experience

A brief look at European experience provides something in the way of positive suggestions. The London exchange is a negotiated, rather than an auction market. The investor gives his order to his broker who deals with, and has exclusive access to, the jobber on the floor of the exchange. The broker normally asks the jobber for a two-way quote without disclosing whether he wishes to buy or sell. The broker charges a commission and the jobber makes his profit on the turn or spread between the sales and purchase prices.

⁹¹ The NYSE apparently is taking another look at the NYSE rule 394 prohibiting the sharing of commissions with nonmember firms. Keith Funston, President of the Exchange, in late September 1965 announced that an exchange committee is working on new proposals for altering the Exchange's commission structure. When asked about the increase in the number of NYSE members being seated on the regional exchanges, Mr. Funston admitted that the dual trading of stocks on the regional exchange was siphoning off trade from the NYSE. He indicated that, in an effort to meet this competition, the NYSE's Cost and Revenue Committee has again taken under consideration changing the Big Board's rules currently barring fee-sharing with nonmembers. Moreover, he indicated that associate memberships were again up for discussion. *Wall Street Journal*, Sept. 22, 1965, p. 3, col. 2.

The London exchange fixes minimum commission rates for brokers. In the case of a transaction in which the price exceeds 2,500 pounds, however, a full commission must be charged only up to that amount and a reduced commission at not less than one-half of the standard rate may be charged on the balance. Furthermore, brokers may at their discretion charge a reduced commission of $\frac{1}{8}$ per cent in transactions in corporate securities of a value of not less than 50,000 pounds, whether by way of sale or exchange.⁹²

It has been estimated that institutional investment in Great Britain has doubled in the last ten years, and that it now comprises from fifty to sixty per cent of the money turnover in stocks.⁹³ A great deal of the institutional business is transacted outside of the London exchange. Merchant banks, operating very much like our third market makers, arrange matching transactions between institutional investors at bargain prices. They are, of course, not subject to exchange restrictions.

Brokers also arrange so-called "put-through" transactions which are somewhat analogous to a "cross" on the floor of the NYSE. In a "put-through" the buyer and seller are matched in the broker's office. Under the rules of the London exchange, the broker must first "offer the shares to the market," thereby utilizing the services of the jobber. When these transactions are run through the market, however, the jobber assumes little risk so receives only a nominal turn. Also, if it is a volume transaction the broker may shave his commission.

An increasing percentage of institutional business is now conducted either outside the exchange or as "put-through" business, the London exchange being used only as a market of final refuge. There are complaints that the British markets in stocks are marked by a "thinness" and "lumpiness" causing wide fluctuations in prices and increasing the risks for both jobbers and the investing public. One commentator warns: "Investors cannot have it both ways. If they choose to deal outside the market or on a put-through basis whenever it suits them, treating the jobber as a buyer or seller of last resort, they cannot then complain that the market is not working properly."⁹⁴ Perhaps the British experience justifies the contention of a certain segment of the NYSE community that "you can't discount a discounter . . . The third market can always narrow its spread below a volume discount."⁹⁵

⁹² Investor's Guide—1963, at 8 (published by Buckmaster & Moore, Members of the London Stock Exchange); THE PRINCIPAL STOCK EXCHANGES OF THE WORLD 194 (Spray ed. 1964).

⁹³ *Jobbers: Down But Not Out*, The Economist, Nov. 16, 1963, p. 679; Spray, *op. cit. supra* note 92, at 183.

⁹⁴ *Jobbers: Down But Not Out*, The Economist, Nov. 16, 1963, p. 680.

⁹⁵ Quoted in Vartan, *A Big Board Splinter—Exchange Troubled by Growth in Sale of Listed Securities*, N.Y. Times, June 24, 1964, p. 49, col. 6.

Germany is a good example of continental practice, although there are variations from country to country. The German approach to the institutional investor is quite different from that of Great Britain or the United States. It requires some understanding of the role played by the German banks in the economy. Unlike American commercial banks, German banks may and do invest heavily in common stocks; they also are the investment bankers to German industry; and they are the principal brokers and dealers in stocks and securities. Indeed, the independent broker, securities dealer or investment banker as we know them are largely nonexistent in Germany.

A German bank or a syndicate of banks will purchase a new issue of common stock or other corporate securities from a German industrial company. Some of these shares may be taken for investment and some for resale to the public. The bank will also buy and sell securities for public customers, sometimes acting as principal, sometimes as broker. The bank is not required to disclose in which capacity it is acting and the customer is not advised of the type of transaction. As bearer shares are widely used, most customers deposit their securities with their bank, giving the bank the right to vote the shares at company meetings.

Since 1957 German banks have been allowed to establish investment companies which sponsor and manage open-end "funds," under a contractual agreement. Investment companies are invariably organized as a "*Gesellschaft mit beschränkter Haftung*" (GmbH), a closely-held company owned and controlled by the sponsoring bank. The investment company manages the assets paid in by the investors and the portfolio securities purchased with those assets. By sponsoring investment companies, the banks have succeeded in retaining the funds of investors, who had previously been savings depositors; these funds were simply transferred from the savings department to the newly organized investment fund. The sponsoring banks not only manage the funds, but perform the underwriting and broker-dealer functions as well.⁹⁶

It is not surprising therefore that main elements of the German stock exchange are the banks and the "*Makler*" (specialists and floor brokers). The banks receive orders from their customers and handle all stock exchange transactions directly for them. The specialists and floor brokers are simply intermediaries who collect orders and determine appropriate prices.⁹⁷ No one is admitted to the stock exchanges unless special authori-

⁹⁶ The writer has relied heavily upon a study by Dr. Karl-Lambert Watrin, *Mutual Funds: Their Law and Organization—A Comparative Study* (Berkeley, 1963), submitted in partial satisfaction for an LL.M. degree at the University of California School of Law, Berkeley.

⁹⁷ My information on the German stock exchange is drawn mainly from *Notes on the Frankfurt Stock Exchange*, prepared by George Hauck & Sohn, Frankfurt am Main, for the

zation is received from the board of governors. Such authorization is invariably given to all banks. The banks may deal in one of four ways: They may forward the order to a specialist or floor trader, acting in their name for the account of the customer; they may match buying and selling orders at corresponding market prices without approaching a specialist or floor broker; they may act as a principal, that is, take securities to be sold into their own portfolio or deliver securities to be purchased from their own portfolio; or they may deal for their own account as buyer or seller.

The official commission rate charged members of the public for the purchase or sale of shares is 0.8 per cent of the total value of the transaction. The rate is 0.4 per cent in the case of bonds. Additionally, when the exchange facilities are used, the specialist on the stock exchange floor receives a fee of 0.7 per cent in the case of shares and 0.75 per cent in the case of bonds. I am advised that officially the rate does not decline in volume transactions in stocks, although there is a declining scale in the case of bonds. In practice, however, the commissions are frequently reduced when an important customer places a large order with the bank.

The official commission rates charged banks, however, is fifty per cent of the public commission rate. Presumably, the bank pays this commission to the stock exchange, a quasi-governmental institution, to support the costs of maintaining the exchange mechanism. The public customer, however, pays 0.8 per cent of the total value of the transaction in commissions to the bank whether or not the stocks are purchased or sold through the stock exchange; the specialist or floor broker receives a fee of 0.7 per cent. If stocks are not purchased or sold on the exchange, the public customer pays the ordinary banking commission, but need not pay the fee for the specialist. Mutual funds are considered as banks under German law and get the preferred rates.

Under the German system an even higher percentage of stock transactions are handled outside of the exchange mechanism. Some observers feel that the published stock exchange prices are not altogether reliable, and that better prices can be negotiated by a sophisticated investor who shops around with various banks. The weaknesses exhibited by the German securities markets since the Spring of 1962 have partially been attributed to the inefficiency of the market structure in that country.

If anything is to be gleaned from this look at the British and continental experience, it is this: The NYSE is unique in failing to recognize the special position of the institutional investor. We have seen that despite the minimum rate schedule the members of the NYSE do in fact engage in price-cutting on commissions.

B. Some Tentative Suggestions

On the basis of my admittedly limited study of the problem, my tentative suggestions are as follows:

1. Volume Discounts

Serious consideration should be given to the adoption of the London Stock Exchange practice of permitting member firms to reduce commissions on volume transactions beyond a certain dollar amount, perhaps limiting the total allowable reduction to fifty per cent of the normal rate. This change in the rate structure would relieve the pressure on institutional investors to trade off-board.

The Securities and Exchange Commission has made sporadic studies of the brokerage rates and for a number of years has supposedly been collaborating with the NYSE in studies of the rate structure and the development of information of costs incurred by member firms. On the other hand, there is a serious question whether the Commission has exercised its supervisory powers in this area with the vigor necessary to "perform the antitrust function of insuring that an exchange will not . . . apply its rules so as to do injury to competition which cannot be justified as furthering self-regulative ends."⁹⁸

At the very least, the Commission should conduct studies of the possible economic effects of a revision of the rules which would permit member firms to split commissions with nonmembers and allow quantity discounts to large volume purchasers. It is entirely possible that the economic mass power of the institutional investors (particularly the mutual funds) might effect changes in commission charges which would tend to increase the flow of individual savings into the funds rather than into individual stock ownership. A further pronounced increase in institutional ownership of common stocks as compared with individual ownership could have profound effects upon the capital markets. The concentration of decision making on investments in fewer units might well have serious economic and political implications.⁹⁹ Assuming that institutional investors are entitled to greater commission savings on volume purchases, how should the costs of conducting a brokerage business, including auxiliary services, be allocated as between institutional investors and other members of the public? Should the rate structure require the individual investor to bear the entire cost of these auxiliary services or should some portion thereby be borne by the institutional investor, even though it has no need for these services? Study should also be made of the possible effect of the removal of anticompetitive conditions in the rate structure

⁹⁸ *Silver v. New York Stock Exchange*, 373 U.S. 341, 358 (1963) (Goldberg, J.).

⁹⁹ See BAUM & STILES, *THE SILENT PARTNERS* (1965); BERLE, *POWER WITHOUT PROPERTY* (1959).

upon the concentration of the brokerage business in fewer units and of the impact of such changes on the regional exchanges.

2. *Associate Membership and Memberships by Publicly Held Corporations*

In view of the break-through of the mutual funds to direct access to the PCSE, the NYSE should be required to re-examine its position with respect to associate membership on the Exchange. The Exchange's objection to associate memberships is that such members would not bear a fair share of the financial burden and would not be subject to the Exchange's rules and regulations.¹⁰⁰ Other exchanges, however, have not found these difficulties to be an insuperable barrier, although the American Stock Exchange has recently taken steps to encourage associate members to become regular members.¹⁰¹ In any event, the NYSE should establish objective standards for membership which protect investors and the public interest.

Furthermore, there seems no good reason for the rule barring publicly held companies from becoming NYSE members. In September 1964 the NYSE named a special committee to consider the question of allowing private investors to acquire a stake in Big Board member firms.¹⁰² The major objection seems to be the fear that the Exchange will not be able to police these firms properly. It is doubtful whether these objections really are substantial.

The SEC reportedly has the matter of exchange membership by publicly owned companies under study. Merrill Lynch, Pierce, Fenner & Smith, Inc., the largest of the Big Board's member firms, has long urged the Exchange to permit public ownership of member firms. This matter should be resolved as a part of any package of new legislation.

3. *Off-board Transactions by Member Firms*

We have seen that, with some exceptions, the effect of NYSE rule 394 is to prohibit a NYSE member firm from dealing off-board in nonexempt listed securities, even though a better execution may be obtained for his customer. This conflicts with the fiduciary duty of an agent to obtain the best price for his principal. A modification along the British practice would solve this problem and still give all of the protection to which the Exchange is fairly entitled. Thus, when a member firm receives an order from a customer, beyond a certain size (depending on the price of the

¹⁰⁰ See statement of Keith Funston, President of the NYSE, Wall Street Journal, Sept. 22, 1965, p. 3, col. 2.

¹⁰¹ Wall Street Journal, Oct. 20, 1965, p. 13, col. 3.

¹⁰² Wall Street Journal, Sept. 23, 1964, p. 3, col. 2.

stock), he should be permitted to contact the Exchange specialist in the stock to obtain a quote; he should also be permitted to check the third market to see if a better execution may be obtained off-board. If the same or better price may be obtained on the floor of the Exchange, taking into account the price and size of the transaction, the Exchange is to be favored; otherwise, the member would be permitted to trade off-board charging a single commission. The member would thus be able to discharge his normal fiduciary obligation to his customer, favoring the Exchange only when a better price cannot be obtained off-board.¹⁰³ The *Silver* doctrine permitting private direct wire connections between member and nonmember firms should continue, so that the Exchange does not extend its monopoly beyond its present limits. This will permit the third market to continue as a competitive factor; indeed, it is inconceivable that the present Exchange mechanism is equipped to handle all transactions, big and small, in NYSE listed securities on the floor of the Exchange.

4. *Splitting Commissions with Nonmember Broker-Dealers*

The third market does not completely meet the needs of the nonmember dealer; it is an institutional market, rather than a brokers' market; and it is confined to a limited number of the stocks most favored by institutional investors. The nonmember broker may of course use it, when possible, and charge a single broker's commission comparable to the NYSE rate. At the same time, however, the whole question of reciprocity between members and nonmembers of an exchange seems uneconomic and indefensible in principle.¹⁰⁴ The SEC and the securities industry must study the problem of reciprocity and devise ways to do openly what is now done as a matter of subterfuge. The growth of the regional exchanges in and of itself would seem to be a healthy development. The reciprocity problem might excite the interest of economists

¹⁰³ Pacific Coast Stock Exchange rule XIII, § 2(a) permits a member, subject to approval, to effect off-board transactions as an agent for a customer after making an equal bid or offer on the exchange, provided (1) the order is for a substantial block of stock market-wise in which the PCSE is the primary market, or (2) the order pertains to a duly traded stock on the Exchange List and the transaction is made with a recognized dealer.

¹⁰⁴ On September 23, 1965, the NYSE announced that it had requested the SEC informally for a ruling whether, if the Big Board granted preferential rates to nonmember broker-dealers, such nonmember might be considered "members" of the Exchange as that term is used in § 3(a)(3) of the Securities Exchange Act of 1934, 48 Stat. 882 (1934), 15 U.S.C. § 78c(a)(3) (1964). Wall Street Journal, Sept. 23, 1965, p. 4, col. 2. The Special Study took the view that "persons qualifying for a special rate as compared with the general public would be 'members' under the definition in sec. 3(a)(3) The exchange thus assumes some responsibility for regulating their conduct, but not necessarily of the same kind or degree as in the case of regular members or member firms." SEC, *Special Study* pt. 2, at 299 n.543.

who are knowledgeable concerning the operation of the securities industry. In any event, the present situation seems far from satisfactory.

5. *Mutual Funds and the Securities Markets*

The SEC has in preparation a mutual fund study to follow the Wharton School Report.¹⁰⁵ The mutual fund form of business organization is a puzzle to me. It is strange that it has congressional sanction in the Investment Company Act of 1940. The best of all worlds would be an amendment of the Investment Company Act to require that mutual funds adopt an integrated form of organization as do banks and other financial institutions. A less drastic approach would be a prohibition against the handling of portfolio, brokerage transactions by a broker-dealer who also sells the mutual fund shares. In any event, however, there should be no change in the law which would absolve the officers and directors of the fund from executing portfolio transactions in the form most advantageous to the fund, rather than to the pecuniary advantage of the advisor, underwriter, and sponsor. The whole problem of reciprocity needs study. It is one thing for a business to buy and sell reciprocally; it is an entirely different matter when a mutual fund board of directors engages in reciprocity or when a bank, acting in a fiduciary capacity, uses its portfolio brokerage to increase the profits of its commercial department.¹⁰⁶ No statute or rule of law should weaken the fiduciary duty to obtain the best execution for the principal or beneficiary which exists at common law and seemingly under the Securities Acts.

C. *Antitrust Laws*

Another approach might be to permit a direct attack on the anti-competitive conditions in the NYSE rate structure through use of the antitrust laws. Professor George J. Stigler of the University of Chicago has recently advanced this point of view.¹⁰⁷ Professor Stigler argues that the Exchange should be competitively organized, with brokers' services set by competitive forces. He is critical of the commission rate structure which he says is "highly discriminatory against higher-priced stocks and larger transactions."¹⁰⁸ And he adds: "[T]he present scheme of com-

¹⁰⁵ *A Study of Mutual Funds*, H.R. REP. NO. 2274, 87th Cong., 2d Sess. (1962).

¹⁰⁶ Cf. McCreary & Guzzardi, *A Customer Is a Company's Best Friend*, *Fortune*, June, 1965, p. 180. For a consideration of reciprocity and the antitrust laws, see Handler, *Emerging Antitrust Issues: Reciprocity, Diversification and Joint Ventures*, 49 *VA. L. REV.* 433-40 (1963). For economic literature on reciprocal purchasing, see *id.* at 435 n.6.

¹⁰⁷ Stigler, *Public Regulations of the Securities Markets*, 37 *J. OF BUS.* 117, 124-33 (1964). Perhaps a lesson may be drawn from a recent study of competitive pricing in air transportation in the Los Angeles-San Francisco market, where the results of nonregulation are surprising. See Note, *Is Regulation Necessary? California Air Transportation and National Regulatory Policy*, 74 *YALE L.J.* 1416 (1965).

¹⁰⁸ *Id.* at 124.

pulsory private price-fixing of brokers' services seems to me wholly objectionable. The replacement of cartel pricing by competition, with review lodged in the Antitrust Division, would confer larger benefits upon investors than the S.E.C. has yet provided."¹⁰⁹

D. Limited Antitrust Immunity and Increased SEC Supervision

Another possible approach is for the exchanges and the SEC to join in a proposal to Congress that the registered exchanges be granted limited statutory immunity from the antitrust laws with the SEC exercising more pervasive supervisory rate-making powers. In order to regulate the competing interests of public investors, nonmember broker dealers, and institutional investors and to protect them from arbitrary or oppressive group action, the statute would accord these persons the right to a hearing before the exchange's governing body before policies or practices affecting them are finally determined. Furthermore, these persons should have the right of appeal to the Securities and Exchange Commission after the exhaustion of remedies at the level of the exchange. The Reed-Bulwinkle Act granting antitrust immunity with respect to certain rate agreements among carriers subject to the jurisdiction of the Interstate Commerce Commission (ICC) provides an analogy and precedent for this type of procedure.¹¹⁰ That act, passed in 1948, authorizes common carriers to apply to the ICC for approval of agreements "relating to rates, fares, classifications, divisions, allowances, or charges . . . or rules and regulations pertaining thereto, or procedures for the joint consideration, initiation or establishment thereof"¹¹¹ Approval by the ICC will relieve the parties from the operation of the antitrust laws in making and effectuating any such agreement, if carried out in conformity with the terms and conditions prescribed by the ICC. The Commission is to grant approval of an agreement only if it finds that relief from the operation of the antitrust laws would further the national transportation policy established by the Interstate Commerce Act. Moreover, the Act specifically provides that approval shall be denied to any agreement which establishes procedures for the joint determination of any matter by a group of carriers unless the Commission finds that "under the agreement there is accorded to each party the free and unrestrained right to take independent action either before or after any determination arrived at through such procedure."¹¹² The latter provision is designed to protect particular carriers from arbitrary or oppressive group action. It thus provides a model for similar legislation applicable to registered exchanges.

¹⁰⁹ *Ibid.*

¹¹⁰ 62 Stat. 472 (1948), 49 U.S.C. § 5b (1964).

¹¹¹ Reed-Bulwinkle Act § 5a(2), 62 Stat. 472 (1948), 49 U.S.C. § 5b(2) (1964).

¹¹² Reed-Bulwinkle Act § 5a(6), 62 Stat. 473 (1948), 49 U.S.C. § 5b(6) (1964).

CONCLUSION

If we may borrow a phrase from Cardozo, "the assault upon the citadel . . . is proceeding in these days apace."¹¹⁸ In fact, certain wings of the fortress have all but fallen. Has not the time now come for the Commission and the Exchange to face up to the problem and attempt to revise the commission rates so as to allow directly what can now only be done indirectly? Institutional investors already obtain volume discounts, either directly through the third market or indirectly by the "end run" and "double reverse." Why should not this fact be recognized and they be allowed to receive such discounts directly?

The *Silver* case poses the interesting problem: What would happen if price-fixing of commission rates were banned as being in violation of the antitrust laws? What effect would this have upon direct stock investment in the United States as compared to indirect investment through institutions? The question is an intriguing one and should be explored from the standpoints of economic and market analysis as well as public policy.

Time marches on, however. What is most needed now is concentrated study of the problem so that we may engage in a rational debate on the improvements needed in the rate structure to allow the Exchange to play its proper role in our modern economy.

¹¹⁸ *Ultramares Corp. v. Touche, Niven & Co.*, 255 N.Y. 170, 174 N.E. 441 (1931).