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THE ABOLITION OF THE CUSTOMER-DIRECTED

GIVE-UP: ITS IMPACT ON MUTUAL FUND

RETAILERS AND REGIONAL EXCHANGES

APPROVED BY

DISSERTATION COMMITTEE

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PART I

THE HISTORY OF CUSTOMER-DIRECTED GIVE-UPS

THE ABOLITION OF THE CUSTOMER-DIRECTED GIVE-UP: ITS IMPACT ON MUTUAL FUND RETAILERS AND REGIONAL EXCHANGES

CHAPTER I

INTRODUCTION

Purpose of the Study

Prior to December 5, 1968, the use of give-ups--payments made by brokers executing orders for mutual funds to other broker-dealers who were not involved in the transactions; these payments came from commissions received by the executing brokers, and were made at the direction of mutual fund managers to reward broker-dealers for selling their fund shares--and certain forms of reciprocal business arrangements were accepted practices in the securities industry. For many years, these practices were accepted without any public criticism from the Securities and Exchange Commission or the major national exchanges. As a result, the industry was to a large degree structured to and dependent on these practices. The main beneficiaries of these practices were: (1) brokerage firms that were not members of any stock exchange, but were involved in the sales of mutual fund shares; and (2) the regional exchanges, because of the dramatic increase in share volume generated by institutional orders, especially those from mutual funds. In a special membership bulletin dated October 10, 1968, the New York Stock Exchange informed its members that customer-directed give-ups would be prohibited, and that the effective date of the prohibition would be December 5, 1968. In addition, the Board of Governors approved a volume discount for the portion of large orders over 1,000 shares and an across-the-board reduction in intra-member rates. Although the mandate for abolishing customer-directed give-ups was issued by the New York Stock Exchange, the Securities and Exchange Commission and the Department of Justice played major roles in the events leading to the decree by the New York Stock Exchange. This aspect will be fully discussed in subsequent chapters.

The purpose of this dissertation is the determination of the impact abolishing give-ups has had on operations of mutual fund retailers and regional exchanges. Before the New York Stock Exchange's prohibition, the National Association of Securities Dealers and other organizations had predicted that if customer-directed give-ups were abolished, a drastic shift in income from smaller to larger brokerage houses would result, so that numerous small firms would find operations unprofitable and would eventually be forced out of business. The regional exchanges also prophesied that if this form of fee-splitting arrangement was disallowed, the loss in trading volume, and consequently in revenues, would be so severe that eventually several of the exchanges would be forced to cease operations.

In investigating the abolition of give-ups and its impact on mutual fund retailers and regional exchanges, attention will be focused not only on the quantitative impact that would relate to variations in trading volume revenues, mergers, admission to membership, and broker-dealer registrations, but also on the non-quantitative impact that would relate to the investing public. This investigation will prove that the allegations of the National Association of Securities Dealers, other organizations, and the regional exchanges were unfounded. This study will also show the extent to which mutual fund retailers and the regional exchanges were affected by the abolition of give-ups.

Scope of the Study

In addition to give-ups, complex reciprocal business practices have developed in connection with institutional trading. Institutional traders use a large part of commissions generated by their portfolio transactions for some form of reciprocity. In exchange for portfolio transactions, mutual fund managers want executing brokers to sell shares of their funds. Many banks insist on demand deposits in exchange for commissions. Insurance companies direct orders to brokers who buy insurance from them. Many pension funds of corporations will not direct orders to brokerage houses which do not recommend purchase of the corporation's stock. Even law firms that act as trustees and investment managers insist on brokers recommending new trust and estate clients in return for orders. The list is endless, and some of the reciprocal practices are so complex that they defy description.

While the customer-directed give-up has been abolished, reciprocal practices continue to flourish. Undoubtedly there are ethical and legal implications with regard to these practices, which should be investigated. This study, however, will not concern itself with reciprocal business practices. It will deal only with give-ups directed by mutual funds, and not give-ups which may have been directed or ordered by other institutional investors. In addition, this study will consider the impact of the prohibition of give-ups only on the major regional exchanges; these are the Midwest, Pacific Coast, and Philadelphia-Baltimore-Washington, and to a lesser degree the Boston, Detroit, Pittsburgh and Cincinnati Stock Exchanges. Approximately 80 per cent of the volume handled by the regional exchanges takes place on the Midwest, Pacific Coast and Philadelphia-Baltimore-Washington Exchanges. The other four exchanges account for almost all of the remaining volume.

Definition of Terms

Customer-directed give-ups. The Securities and Exchange Commission, in its Release No. 8239, defines a give-up as

> . . . a payment by the executing broker to other broker-dealers of a part of the minimum commission he is required to charge his customers. The recipient of a give-up check may have had nothing whatsoever to do with the transaction for which the commission is charged and in fact may not

> even know of the transaction or where or when it was executed.[1]

Mutual fund managers used give-ups to reward broker-dealers who sold their fund shares, and for research ideas furnished by the broker-dealers. The income derived from give-ups was income in addition to the regular commission or sales load received by the broker-dealers. It should be noted that managers of mutual funds were reluctant to reward broker-dealers who sold their fund shares with direct orders for execution, because in most cases they neither had the expertise nor the capital requirements to handle large block trades.

Regional exchanges. In 1969 there were fourteen regional exchanges, all of which were located outside of New York City. Ten of these were registered with the Securities and Exchange Commission, while the remaining four were exempt because of their small volume of transactions. The three principal regional exchanges are the Midwest, the Pacific Coast and the Philadelphia-Baltimore-Washington. The other registered exchanges are the Boston, Detroit, Pittsburgh, Cincinnati, Salt Lake City, San Francisco Mining and Spokane exchanges. The last three are the mining exchanges and in many respects differ from the others since they deal in mining and oil shares selling at extremely cheap prices. At the beginning of 1970, the Pittsburgh Exchange

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[1] Securities Exchange Act of 1934. Release No. 8239. January 26, 1968, p. 3.

merged with the Philadelphia-Baltimore-Washington Exchange.

Mutual fund. The expressions mutual fund and open-end investment company are used interchangeably. From a technical viewpoint a mutual fund is an open-end investment company because it must stand ready to redeem outstanding shares any time they are presented by investors. Thus the number of shares of a mutual fund or investment company is not fixed, but varies as new shares are sold to and redeemed by investors.

Others. In other sections of this dissertation, various organizations, both governmental and non-governmental, will be mentioned. Since most of these institutions are long named, abbreviations will be used for the sake of brevity. The following is a list of these organizations and their abbreviated forms:

1. Securities and Exchange Commission (SEC).
2. National Association of Securities Dealers (NASD).
3. Investment Company Institute (ICI).
4. Independent Broker-Dealers' Trade Association (IBDTA).
5. American Stock Exchange (AMEX).
6. New York Stock Exchange (NYSE).

Because of the importance of most of these organizations to the study, a special section has been devoted to their descriptions and functions.

Organization of the Dissertation

Since give-ups are inextricably tied to institutional trading, especially mutual fund transactions, Part I of the dissertation is partially devoted to a description of the growth in institutional portfolio activity, especially that of mutual funds. The background of the give-up and the events leading to its abolition is described. Finally, in Part I, the viewpoints and roles played by the SEC and the NYSE are described.

Part II concerns itself with the impact of the abolition of customer-directed give-ups on mutual fund retailers. This section reviews the studies of the National Association of Securities Dealers and the Independent Broker-Dealers' Trade Association. These are the only two previous studies made to determine the effects of proposed legislation on the mutual fund industry. Parts of these studies relate to the give-up problem. The major section of Part II is devoted to the author's questionnaire survey of a statistically selected group of mutual fund retailers designed to determine how the prohibition of give-ups has affected their business operations.

Part III describes the impact of the abolition of the give-up on the major regional exchanges. The reactions of the regional exchanges to the original proposals of the NYSE and SEC are discussed. Share and dollar volume growth for the period 1960-1969 are reviewed, together with the increase in block transactions over the same period. Especially noted here is the fact that most of the exchanges, both regional and national, did not have complete records on block transactions. In some cases, estimates by the regional exchanges were made. Finally, the results of personal interviews with regional exchange members and questionnaires are examined to determine the effect of the ban. Steps taken by the regional exchanges to offset expected loss of revenues arising from the give-up prohibition are analysed to determine their success or failure.

Part IV, which is the final portion of the dissertation, critically analyses the legal implications of the prohibition. This analysis necessitates an examination of the commission rate structure of the New York Stock Exchange, for there is little doubt that the give-up and the minimum commission rate are inter-related. Comments are made on the value of the volume discount that became effective at the same time the give-up was abolished. In addition, the author gives his own views on the propriety of prohibiting give-ups and the implications of the prohibition on the investing public.

Review of Previous Investigations

Although there have been numerous articles in the investment journals, periodicals, and newspapers relating to the prohibition of the customer-directed give-up and its effects on mutual fund retailers and the regional exchanges, it is doubtful that any of the findings were based on empirical research.

Only two studies were actually undertaken, and these studies were not solely done to determine the effects of the abolition of give-ups, but rather to try to determine the effects of total proposed mutual-fund legislation on the mutual-fund industry. Parts of these investigations were concerned with the give-up problem. One study was instigated by the National Association of Securities Dealers, and the other by the Independent Broker-Dealers' Trade Association. Clearly, neither of these associations are impartial observers. The NASD is a nonprofit organization which administers and regulates the over-the-counter market to which a great many broker-dealers retailing mutual funds belong. The IBDTA is also a nonprofit organization of approximately four hundred members. Any broker-dealer who is not a member of the New York Stock Exchange is eligible for membership in the IBDTA. In addition to the lack of impartiality, certain inadequacies were found in these studies which cast some doubts on the validity of the conclusions reached by the NASD and the IBDTA. In Part II, both studies are critically reviewed. While some attempt has been made to determine the impact of the abolition of give-ups on mutual fund retailers, no investigation has been made to determine the impact on the regional exchanges. To the author's knowledge, this attempt is the first.

Sources of Data

Since the prohibition of the customer-directed give-up occurred less than two years ago, there has been very little empirical research undertaken in this area. As a result, most of the information in this study is of a primary nature. The following schedule shows actual interviews with the regional exchanges and other organizations. In addition to those mentioned in the schedule, the author communicated with the New York, American, Boston and Pacific Coast Stock Exchanges, and other organizations by letter and telephone. Personal interviews were held in the following cities:

Cities Visited	Regional Exchanges
Philadelphia	Philadelphia-Baltimore-Washington Exchange
Pittsburgh	Pittsburgh Exchange
Cincinnati	Cincinnati Stock Exchange
Detroit	Detroit Stock Exchange
Chicago	Midwest Stock Exchange
	Organizations
Washington	The Securities and Exchange Commission
	The National Association of Securities Dealers
	The Investment Company Institute
Springfield, Mass.	The Independent Broker-Dealers' Trade Association

A questionnaire survey was also undertaken involving 540 broker-dealers retailing mutual fund shares. The Securities and Exchange Commission permitted the author to use its computerized registration sheets on broker-dealers to select a sample for the questionnaire.

CHAPTER II

INSTITUTIONAL TRADING AND THE GROWTH OF THE MUTUAL FUND INDUSTRY

Institutional and Mutual Fund Trading on the New York Stock Exchange

In the past twenty years, institutional participation in the stock market has been phenomenal. At the end of 1949, the market value of all New York Stock Exchange listed stock was approximately 76.3 billion dollars. Of this amount, financial institutions held about 9.7 billion dollars or 12.7 per cent. By 1969 the total market value of all NYSE listed stock was 629.5 billion dollars, of which the holdings of financial institutions amounted to 24.1 per cent or 151.5 billion dollars. Table 1 illustrates the approximate holdings of NYSE listed stocks by financial institutions for the period 1949-1969.

The most striking increases were shown by open-end investment companies and corporate non-insured pension funds. Additional evidence of the increased participation in the stock market by institutions is shown in Table 2.

While member trading has remained fairly steady as a per cent of total volume, the public's proportion of share volume has declined from approximately 53 per cent in 1960 to about 35 per cent in 1969. Institutional trading during this period increased from roughly 24 per cent to 41 per cent of total share volume.

TABLE 1

FINANCIAL INSTITUTION HOLDINGS OF NEW YORK
STOCK EXCHANGE LISTED STOCKS
YEARS 1949, 1959, 1967-1969

Type of Institution	Year Ending 1949	1959	1967	1968	1969
	(Billions of Dollars)				
Insurance Companies --Life and Non-Life	2.8	8.6	18.7	22.1	21.5
Investment Companies					
Open-end	1.4	11.6	33.2	43.9	39.8
Closed-end	1.6	5.2	4.9	5.5	4.3
Non-Insured Pension Funds					
Corporate	0.5	11.8	40.6	49.2	46.5
Others--Private, State and Local Government	0.0	1.1	5.0	6.2	6.3
Nonprofit Institutions College and University Endowments, Foundations and others	3.2	12.8	25.9	30.9	28.4
Common Trust Funds	0.0	1.4	3.5	4.3	4.1
Mutual Savings Banks	0.2	0.3	0.6	0.7	0.6
Total	9.7	52.8	132.4	162.8	151.5
Market Value of all NYSE Listed Stocks	76.3	307.7	605.8	692.3	629.5
Estimated Per Cent Held by Institutions	12.7	17.2	21.9	23.5	24.1

Source: New York Stock Exchange Fact Book, 1970, p. 47.

TABLE 2

MAJOR SOURCES OF VOLUME ON THE NYSE
FOR SELECTED YEARS

	Per Cent of Total Share and Dollar Volume					
	Public Individuals		Institutions and Intermediaries		NYSE Members	
Period	Shares	Value	Shares	Value	Shares	Value
1960	52.6	43.8	24.3	28.9	23.1	27.3
1961	51.4	46.1	26.2	29.2	22.4	24.7
1963	53.4	48.2	23.9	26.2	22.7	25.6
1965	48.5	41.3	31.4	36.5	20.1	22.2
1966	43.2	38.4	32.5	34.8	24.3	26.8
1969	34.5	30.0	41.1	45.6	24.4	24.4

Source: New York Stock Exchange Fact Books, 1969 and 1970, pp. 48-49.

If institutional trading on the NYSE is considered only in terms of public volume, that is, total volume less volume arising from member trading, the phenomenal growth of institutional participation is even more apparent. A review of Table 3 shows the dramatic comparison of the distribution of NYSE public volume for three selected years.

According to the NYSE Fact Book, the relationship between public individuals and institutional trading on all other markets showed that in 1969, public individuals were responsible for

TABLE 3

DISTRIBUTION OF PUBLIC VOLUME ON THE NYSE
FOR 1960, 1966 AND 1969

	Per Cent of Total Share and Dollar Volume			
	Public Individuals		Institutions and Intermediaries	
Period	Shares	Value	Shares	Value
1960	68.6	60.7	31.4	39.3
1966	57.6	52.5	43.0	47.5
1969	45.6	39.7	54.5	60.3

Source: New York Stock Exchange Fact Book, 1970, p. 50.

79 per cent of the public share volume executed on these markets by NYSE member firms, and 67 per cent of the dollar value. This type of information was available for the first time in 1969, and is significant since it shows clearly how dominant institutional trading is on the NYSE.

The percentage distribution of share volume by institution and intermediaries on the NYSE and all other markets is shown in Table 4.

Between 1960 and 1969, mutual funds increased their share volume by more than 50 per cent. Important even in 1969 was a slight increase in mutual fund percentage of share volume which occurred despite the condition of the securities industry and the decline in total volume on the NYSE. While extremely complex

TABLE 4

SHARE VOLUME DISTRIBUTION BY INSTITUTIONS AND INTERMEDIARIES FOR 1960, 1966 AND 1969

Institutions and Intermediaries	Per Cent of Total Share Volume			
	New York Stock Exchange			All Other Markets
	1960	1966	1969	1969
Commercial Banks or Trust Companies	40.6	38.8	36.4	27.8
Mutual Funds	17.5	25.8	26.6	17.3
All Other	41.9	35.4	37.0	54.9
Total	100.0	100.0	100.0	100.0

Source: New York Stock Exchange Fact Book, 1970, p. 50.

reciprocal arrangements have been arising from all types of institutional business, the problem of give-ups has been associated mainly with mutual fund transactions. Since the purpose of the dissertation is to investigate the impact of the abolition of customer-directed give-ups on mutual fund retailers and regional exchanges, emphasis will be placed on the growth of the mutual fund industry.

Table 5 shows mutual fund holdings as a per cent of the market value of all NYSE stocks for selected years.

TABLE 5

MUTUAL FUND HOLDING AS A PER CENT OF MARKET VALUE OF ALL NYSE LISTED STOCK YEARS 1949, 1959, 1967-1969*

	Year Ending				
	1949	1959	1967	1968	1969
Market value of all NYSE listed stock (billions of dollars)	76.3	307.7	605.8	692.3	629.5
Market value of mutual fund holdings (billions of dollars)	1.4	11.6	33.2	43.9	39.8
Mutual fund holdings as a per cent of market value of all NYSE listed stock	1.8	3.8	5.5	6.3	6.3

Source: Calculations made from data obtained in the New York Stock Exchange Fact Book, 1970.

*The figures shown by the ICI for mutual fund holdings as a per cent of the market value of all NYSE listed stock differ slightly from those shown in Table 5.

According to the 1970 Mutual Fund Fact Book of the Investment Company Institute, mutual fund holdings as a per cent of the market value of all NYSE listed stocks were as follows:

1949	1.8
1959	3.7
1967	5.2
1968	5.4
1969	5.5

The ICI figures are estimates, while those of the NYSE are actual. The figure for 1969, however, is a preliminary estimate. The author was unable to determine the reasons for the differences in both sets of figures.

Institutional and Mutual Fund Trading on the American Stock Exchange

The only available information on institutional activity, including that of mutual funds, is contained in the Public Transaction Studies of 1966 and 1967 of the American Stock Exchange. Data on institutional trading for 1968 and 1969 were not available. The following table shows the distribution of total volume for the three major categories: (1) public individuals; (2) public institutions; and (3) members for their own accounts.

TABLE 6

SOURCES OF VOLUME ON THE AMERICAN STOCK EXCHANGE FOR 1966 AND 1967

	Per Cent of Total Volume	
Category	1966	1967
Public individuals	63.3	64.0
Public institutions	10.9	11.8
Members for their own accounts	25.8	24.2
Total	100.0	100.0

Source: American Stock Exchange Data Book, 1969, p. 42.

Substantially less institutional trading takes place on the American Stock Exchange than on the New York Stock Exchange. The AMEX Public Transaction Study of 1967 reported that public institutions accounted for 11.8 per cent of total volume on the AMEX, as compared to 32.5 per cent on the NYSE.[2]

The latest available information regarding mutual fund activity on the AMEX is for the years 1966 and 1967, as shown in Table 7.

TABLE 7

PUBLIC INSTITUTION VOLUME ON THE AMERICAN STOCK EXCHANGE FOR 1966 AND 1967

	Per Cent of Total Volume	
Type of Public Institution	1966	1967
Nonmember broker-dealer	3.1	2.9
Commercial banks and trust companies	2.2	2.9
Mutual funds	0.7	1.1
Nonfinancial corporations	--	1.2
Investment clubs	--	0.5
Other	4.9	3.2
Total	10.9	11.8

Source: AMEX Databook, 1969, p. 42.

[2]The AMEX in Brief, Revised Edition, p. 6.

A comparison of mutual fund activity on both the NYSE and AMEX by per cent of total volume and number of shares is given in Table 8.

TABLE 8

MUTUAL FUND ACTIVITY ON THE NYSE AND AMEX FOR 1966 AND 1967

	NYSE 1966	AMEX 1966	NYSE 1967	AMEX 1967
Share volume (millions of shares)	1,899.5	690.8	2,530.0	1,145.1
Mutual fund share of total volume (millions of shares)	72.2	4.8	139.2	12.6
Mutual fund trading as a per cent of share volume	3.8	0.7	5.5	1.1

Source: New York Stock Exchange Fact Book, 1970, p. 72.

AMEX Databook, 1969, p. 36.

Other calculation made from data in both sources mentioned.

The most important reasons for mutual fund preference to NYSE shares would be (1) the NYSE is a much older and established exchange than the AMEX; (2) a larger number of stocks are listed on the NYSE; (3) companies listed on the NYSE are generally larger and better known than those listed on the AMEX; and (4) companies listed on the AMEX normally move to the NYSE as soon as they can meet the listing requirements of the latter exchange.

NYSE and AMEX Block Transactions

Another measure of the increased participation of financial institutions in the stock market is derived from the statistics on block transactions for both major exchanges. For both exchanges, a block transaction is defined as one in which 10,000 shares or more are traded on the floor of the exchange. Table 9 gives details of block transactions on the NYSE for the period 1965-1969, and on the AMEX for 1966-1969.

Block trading as a per cent of total volume on the NYSE went from 10.0 per cent in 1968 to 14.1 per cent in 1969, or an increase of approximately 40 per cent. On the AMEX the increase was almost 100 per cent during the same period. These increases took place despite a decline in total volume on both the exchanges. On the NYSE total volume in 1969 was 2,850,785,000 shares compared to 2,931,556,000 in 1968, a decline of 2.8 per cent. The percentage decline on the AMEX was 13.5 per cent, with volume falling to 1,240,742,000 shares in 1969 from 1,435,766,000 in 1968. The increase in block volume trading on the two major exchanges was apparently not offset by declining volume on the regional exchanges, but seemed to result solely from the increase in institutional trading.

TABLE 9

NYSE BLOCK TRANSACTIONS, 1965-1969 AND
AMEX BLOCK TRANSACTIONS, 1966-1969

Year	Block Volume: Number of Transactions	Millions of Shares	Per Cent of Reported Volume	Market Value (millions of dollars)
NYSE				
1965[a]	2,171	48.3	3.1	1,857.4
1966[a]	3,642	85.3	4.5	3,303.2
1967[a]	6,685	169.4	6.7	6,810.9
1968[a]	11,254	292.7	10.0	12,971.6
1969[a]	15,132	402.1	14.1	15,609.5
AMEX				
1966[b]	387	6.8	1.0	119.1
1967[c]	1,065	18.8	1.6	338.4
1968[c]	1,682	36.1	2.5	1,108.8
1969[c]	2,463	60.4	4.9	1,567.8

[a]Source: New York Stock Exchange Fact Book, 1970, p. 12.

[b]Source: AMEX Databook, 1969, p. 36.

[c]Source: Letter from John C. Ford, Education Services Manager, American Stock Exchange, March 18, 1970.

The Growth and Development of the Mutual Fund Industry

Mutual fund assets in 1940 amounted to approximately $500 million, and the number of shareholder accounts totalled about 296,000. At the end of 1969 assets amounted to more than $48 billion and shareholder accounts totalled about 10.4 million. Two major reasons for the huge increase in assets are: (1) the long-term upward trend of securities prices; and (2) the continued net purchases of fund shares by the investing public. The following tables show (1) the growth in assets and shareholders' accounts for the period 1960-1969, and (2) the net increase in capital for the same period.

TABLE 10

NET ASSETS AND SHAREHOLDER ACCOUNTS OF MUTUAL FUNDS FOR THE PERIOD 1960-1969

Year Ending	Assets (000,000's of Dollars)	Number of Accounts (000's)
1960	17,026	4,898
1961	22,789	5,319
1962	21,271	5,910
1963	25,214	6,152
1964	29,116	6,302
1965	35,220	6,709
1966	34,829	7,702
1967	44,701	7,904
1968	52,677	9,080
1969	48,291	10,392

Source: Investment Company Institute, Mutual Fund Fact Book, 1970, p. 16.

TABLE 11

NET INCREASE IN CAPITAL OF MUTUAL FUNDS
FOR THE PERIOD 1960-1969

Year Ending	Sales of Own Shares (000,000's of Dollars)	Repurchases of Own Shares (000,000's of Dollars)	Net Increase (000,000's of Dollars)
1960	2,097	842	1,255
1961	2,951	1,160	1,791
1962	2,699	1,123	1,576
1963	2,459	1,505	954
1964	3,403	1,874	1,529
1965	4,358	1,962	2,396
1966	4,672	2,005	2,667
1967	4,670	2,744	1,925
1968	6,820	3,839	2,981
1969	6,718	3,662	3,057

Source: Investment Company Institute, Mutual Fund Fact Book, 1970, p. 14.

In 1969, despite the depressed conditions of the securities markets, investors purchased $6.7 billion of new mutual fund shares compared with $6.8 billion in 1968. Redemptions totalled approximately $3.7 billion in 1969; the corresponding amount in 1968 was $3.8 billion. The net increase in capital during 1969 amounted to approximately $75 million more than in 1968. Considering the mass liquidation of portfolio holdings by investors in 1969, and the near panic conditions which existed, a greater percentage of redemptions might have been expected.

In Table 10, total net assets of mutual funds for the period 1960-1969 were shown. Interesting to note is the distribution of mutual fund assets by type of portfolio security as shown in Table 12.

TABLE 12

DISTRIBUTION OF MUTUAL FUND ASSETS FOR THE PERIOD 1960-1969

Year	Assets (000,000's of Dollars	Net Cash and Equivalent (%)	Corporate Bonds (%)	Preferred Stock (%)	Common Stocks (%)
1960	17,026	5.7	7.3	4.2	82.8
1961	22,789	4.3	6.9	3.4	85.4
1962	21,271	6.2	7.6	3.5	82.7
1963	25,214	5.3	7.1	2.9	84.7
1964	29,116	4.6	7.4	2.4	85.6
1965	35,220	5.1	7.3	1.7	85.9
1966	34,829	8.5	8.4	1.4	81.7
1967	44,701	5.7	6.6	1.7	86.0
1968	52,677	6.0	6.5	3.2	84.3
1969	48,291	8.0	7.4	2.5	82.1

Source: Investment Company Institute, Mutual Fund Fact Book, 1970, p. 32.

The relationship between the various portfolio securities appear relatively constant. Investment in common stocks ranged between 81.7 per cent in 1966 and 86.0 per cent in 1967. Holdings of net cash and equivalent was at a high of 8.5 per cent in 1966, and at a low of 4.3 per cent in 1961. Again in 1966, assets in the form of corporate bonds was 8.4 per cent, its peak for the ten year period. An inverse relationship exists between the state of the market as measured by any of the stock market indexes and the level of bond holdings. In 1966 and 1969 when a drastic decline in security values occurred, assets in the form of common stock were at their lowest, while holdings in the forms of cash and bonds were at their peak.

Despite adverse economic conditions in 1969, purchases of portfolio securities (common and preferred stocks and bonds) by mutual funds were the highest in the industry's history. Total purchases amounted to $24.8 billion while total sales were $22.1 billion, for a net purchase total of approximately $2.7 billion. Purchases of common stock alone amounted to $22.0 billion in 1969, compared with sales of $19.8 billion; net purchases of common stock were about $2.2 billion. Tables 13 and 14 review the purchases, sales and net purchases of mutual funds for the ten year period 1960-1969.

TABLE 13

PURCHASES, SALES AND NET PURCHASES OF PORTFOLIO SECURITIES BY MUTUAL FUNDS FOR THE PERIOD 1960-1969

Year	Purchases (000,000's of Dollars)	Sales (000,000's of Dollars)	Net Purchases (000,000's of Dollars)
1960	3,314	2,315	999
1961	4,620	3,249	1,371
1962	4,533	3,403	1,130
1963	4,363	3,603	760
1964	5,340	4,257	1,083
1965	7,571	6,002	1,569
1966	11,520	10,167	1,353
1967	16,318	14,821	1,497
1968	22,013	20,105	1,908
1969	24,807	22,140	2,667

Source: Investment Company Institute, Mutual Fund Fact Book, 1970, p. 38.

TABLE 14

PURCHASES, SALES AND NET PURCHASES OF COMMON STOCKS BY MUTUAL FUNDS FOR THE PERIOD 1960-1969

	Purchases (000,000's of Dollars)	Sales (000,000's of Dollars)	Net Purchases (000,000's of Dollars)
1960	2,785	2,001	784
1961	3,956	2,756	1,200
1962	3,696	2,719	977
1963	4,010	3,232	778
1964	4,768	3,844	884
1965	6,530	5,166	1,364
1966	10,363	9,320	1,043
1967	14,926	13,325	1,601
1968	20,102	18,496	1,606
1969	22,012	19,773	2,239

Source: Investment Company Institute, Mutual Fund Fact Book, 1970, p. 38.

Commissions Generated by Mutual Fund Orders

In September of 1969, Mr. John C. Bogle, Chairman of the Investment Company Institute, which represents mutual funds in matters of legislation and regulation, stated that the volume discount instituted by the NYSE in December of 1968 had reduced Mutual Funds commission costs by approximately 25 per cent.[3] The growth in recent years in commissions generated by mutual fund orders had been as dramatic as the growth in fund trading. According to a Business Week estimate,[4] commissions paid by mutual funds in the period 1963-1967 were:

1963	$ 59.7 million
1964	72.0 million
1965	101.8 million
1966	162.6 million
1967	233.0 million

Business Week's estimates were based on data obtained from the Investment Company Institute. When the author visited Washington, he spoke to Mr. Alfred P. Johnson, Vice-President and Economist of ICI, about Business Week's estimates. Mr. Johnson had some doubts about the exactness of the commissions since they were not obtained directly from ICI. The Business Week estimates were determined by taking the average of total purchases and total sales of portfolio securities for the year, and applying a

[3]"Mutual Fund Official Sees Some Problems in Exchange Membership, Commission Cuts," Wall Street Journal, September 16, 1969, p. 3.

[4]"Give-ups Kick Back on Funds," Business Week, July 27, 1968, p. 97.

1.5 per cent factor. For example, total purchases of securities by mutual funds amounted to $16.3 billion in 1967, and sales to $14.8 billion; the average of purchases and sales was approximately $15.6 billion; 1.5 per cent of this figure is roughly $233 million. If the same factor is applied to the averages of purchases and sales for 1968 and 1969, the commission costs would be: 1968, $315.9 million; and 1969, $352.1 million.

The use of the 1.5 per cent factor is debatable since this supposes that the average share price in mutual fund transactions is approximately $14, based on transactions of 10,000 share blocks. During the period 1963-1969, the average price of a share on the NYSE varied between $39.90 to $44.00. The major part of mutual fund trading is in NYSE listed stocks; in addition the favorites of many funds have been the high priced glamor stocks. The factor of 1.5 per cent used by Business Week appears then to be high. Since exact commission costs of mutual funds are impossible to obtain, not even from ICI, the estimates of Business Week for the period 1963-1967 will be accepted, and the 1.5 per cent factor will be used to obtain estimates for 1968 and 1969. Any method used to estimate commissions generated by mutual funds is subject to criticism. The main reasons for estimating these commissions are: (1) to show the rapid growth in commissions; and (2) to show the significant decline in 1969, supposedly caused by the volume discount. If commissions for 1968 and 1969 are adjusted to reflect the volume discount which became effective in December 1968, then estimated commissions paid by mutual funds during 1963-1969 would have been as follows:

1963	$ 59.7 million
1964	72.0 million
1965	101.8 million
1966	162.6 million
1967	233.0 million
1968	309.5 million
1969	264.1 million

Supposedly, the volume discount would result in substantial savings for mutual funds. However, many of the respondents to the author's questionnaire, and many individuals connected with the securities industry who were interviewed by the author expressed doubts that the volume discount has been beneficial to the mutual funds. These individuals claim that mutual funds have been breaking up large orders, and splitting these orders among many brokers; previously, the lead broker technique had been employed. This technique is fully described at the beginning of Chapter III. If this assumption is correct, and the evidence suggests that it is, then Mr. Bogle's statement of reduced commission costs cannot be completely accepted, especially since the ICI does not keep records on commissions generated by mutual fund orders.

CHAPTER III

EVENTS LEADING TO THE PROHIBITION OF CUSTOMER-DIRECTED GIVE-UPS

Since the Investment Company Act became effective in 1940, and probably prior to the enactment, mutual funds with portfolio orders compensated brokerage firms that sold their shares. This compensation was a reward for research ideas and other services provided by the brokerage firms. Many of the brokerage firms to which orders were given by mutual funds were small and lacking in the expertise to execute the orders in an efficient manner. Since serious questions were being raised as to whether trades were being executed by funds as efficiently as possible, the lead broker technique was developed by mutual funds in approximately 1951. This approach was a technique whereby a lead broker, usually a large member firm of the New York Stock Exchange, would execute the whole order from a mutual fund and split the commission with broker-dealers who otherwise would have participated in executing the order. The lead broker technique was simply a method devised to prevent a large order from being broken into several smaller orders which would normally be executed on less favorable terms. This splitting or sharing of the commission between the lead broker and other brokerage firms has been better known as the give-up. The rules of the New York

Stock Exchange did not permit its members to share commissions with non-member firms. This rule led to another technique being developed, the execution of mutual fund orders on the regional exchanges where fee-splitting rules were more liberal. New York and American Stock Exchange member firms simply joined the regional exchanges, executed large mutual fund orders there, and were able to comply with the directives of the mutual fund to share the commission generated by these orders with other brokerage firms.

In Chapter II, the growth in institutional trading, especially that of mutual funds, was described in some detail. The relationship between the increase in institutional trading and the increase in the number of block transactions executed on the various exchanges was also discussed. Little doubt exists that the dramatic increase in institutional trading had seriously impaired the effectiveness of the commission rate structure of the New York Stock Exchange. To be noted is the fact that the rate structure formulated by the NYSE had always been adopted by the other securities exchanges, and that the last revision of the NYSE commission structure had taken place in 1959. On December 5, 1968 when the give-up was prohibited, a volume discount was instituted by the NYSE on the portion of an order exceeding 1000 shares. On an order up to and including 1000 shares, no change in commissions occurred. Until the inception of the volume discount, the commission rate structure was based on a single round lot of 100 shares. Thus the commissions charged on an order of 5000 shares was equivalent to 50 times the commission charged on 100 shares. Regardless of the size of the order, no volume discount was obtainable. Anyone who was not an exchange member was charged the minimum commission. While a broker executing an order of 5000 shares could be expected to incur greater costs than on an order of 100 shares, most students of the market accepted the view that the cost was not equivalent to 50 times the cost of a 100 share order. Therefore, institutional orders, including those of mutual funds, were quite profitable to large brokerage firms, although these firms had to maintain institutional trading departments which increased their operating costs.

Because of the profitability of institutional orders, there was fierce competition between brokerage houses for these types of orders. Mutual fund and other institutional managers, aware of the intense competition for their orders, were able to utilize the willingness of brokerage firms to accept less than minimum commissions, and were able either to direct the give-up of part of the commission to other brokers, or to use the rebate to lower their management fees to the funds.

For many years prior to its proposed ruling on give-ups of commissions, the Securities and Exchange Commission had been aware of the give-up and its relationship to the rigidity of the minimum commission rate structure of the New York Stock Exchange. As early as 1953, the New York Stock Exchange Special Committee on Rate Structures had concluded that the cost of an order and its size were related and had recommended a volume discount.[1] The recommendation, however, was not acted on until 1968, and for different reasons than those originally proposed. In 1959, the Securities and Exchange Commission suggested to the New York Stock Exchange that a volume discount was desirable and stated that "an Exchange committee will further study the use of a so-called volume block discount for transactions involving multiple round lot units."[2]

In the Report of the Special Study of Securities Markets published in 1963, the SEC for the first time critically reviewed the methods by which mutual funds allocated brokerage commissions generated by their orders. For the first time the relationship between the give-up and the round-lot commission structure was examined in detail. The Special Study of the Securities Markets pointed out that

> . . . the give-ups for volume and block customers stem from the fact that the New York Stock Exchange commission rate structure does not formally recognize such customers as deserving treatment different from the average round lot customer.[3]

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[1]Securities and Exchange Commission, <u>Report of the Special Study of Securities Markets</u>, Part II (1963), pp. 332-333.

[2]<u>Securities Exchange Act Release No. 5889</u> (February 20, 1959), quoted in Securities and Exchange Commission, <u>Report of the Special Study of Securities Markets</u>, Part II (1963), p. 332.

[3]Securities and Exchange Commission, <u>Report of the Special Study of Securities Markets</u>, Part II (1963), p. 318.

On July 18, 1966 the SEC sent out a circular to the National Association of Securities Dealers and the national exchanges expressing its concern over the give-up practice. In its 1967 Annual Report, the SEC also pointed out that

> . . . it is apparent that a commission rate structure which requires the same commission per share for large blocks as for 100 share blocks is unrelated to the cost of handling transactions, a fact reflected in the willingness of exchange members to forego a large proportion of their regular commissions derived from mutual fund business, "through give-ups", "give-aways" and "reciprocal arrangements".[4]

The New York Stock Exchange Release of January 2, 1968, to its Members and Allied Members on a Commission Rate Structure Proposal

In this release, the NYSE pointed out that the principal unsolved problem facing the securities industry was the commission rate structure of the Exchange. The rate structure had been heavily criticized by Congress, government agencies, the SEC and the press. It further pointed out that the Exchange enjoyed the right of self-regulation and operated under a government-approved rate structure and certain anti-trust immunities. The NYSE admitted that the minimum commission rate no longer could be considered a minimum because large institutional investors and non-member brokerage firms were employing a wide range of practices to evade the minimum rate. This practice resulted in

> . . . an intricate maze involving give-ups, give-aways, reciprocal practices, manufactured participations in trades,

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[4]Securities and Exchange Commission, 33rd Annual Report (1967), p. 8.

transported trades moved from one Exchange to another, all of which result in a leakage of the commission dollar.[5]

Because of increased institutional activity and the special characteristics of institutional business and demands, the NYSE believed a change in its commission charges was necessary and proposed the following:

1. Incorporation of a volume discount in the minimum commission schedule, the amount and nature to be subsequently determined.

2. Continuation of the practice of customer-directed give-ups on their own transactions with a limitation on the percentage amount which could be given-up.

3. Prohibition of reciprocal practices which result in "de facto" rebates to NYSE commissions even where those arrangements involved markets other than the NYSE floor; this provision would depend in the SEC's prohibiting such practices in other markets.

4. A discount in the minimum commission schedule for non-member brokers.

5. Adoption of rules limiting membership and broker-dealer allowances to bona-fide broker-dealers.

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[5]NYSE Release to Members and Allied Members on Commission Rate Structure Proposals (January 2, 1968), pp. 1-2.

Rule 10b-10 of the Securities and Exchange Commission

On January 26, 1968, the SEC issued Securities Exchange Act Release No. 8239. The release commented on the proposals of the New York Stock Exchange and then went on to detail the reasons for its proposed rule 10b-10, and also those leading to the New York Stock Exchange pending rate structure revisions. Some interesting examples of the give-up and reciprocal business were pointed out by the SEC. For example, give-ups were frequently used in connection with "cross" transactions. A "cross" occurs when an order cannot be adequately executed through the normal auction process on the floor of an exchange and the broker handling the order has to find the other side of the trade off the floor of the exchange. In other words, the broker has to locate a buyer or seller depending on the nature of the order, and then "cross" the order on the floor. Exchange rules did not permit members to complete crosses either on the over-the-counter market or in their offices at a negotiated commission, but members were permitted to send the order to any regional exchange to which they belonged. By this method, the brokers were able to give up commissions on the cross according to the give-up rules of the specific exchange. Thus, mutual funds and institutional brokers were able to utilize the rules of the regional exchanges with respect to the types of brokers who were permitted to receive give-ups.

New York Stock Exchange member firms, at the direction of mutual funds, compensated non-members with cash payments and credited these payments to over-the-counter trades for unconnected customers. This device was used whether or not commissions were actually charged on the over-the-counter market trades. The brokers who were compensated had absolutely no participation in the trades.

Some managers of funds, especially those whose shares were sold by captive sales forces, created affiliates which were members of the National Association of Securities Dealers. Some of these affiliates were also members of regional exchanges. The fund managers then directed the lead brokers to give the affiliates give-ups and reciprocal business. The income received by the affiliates was credited to the advisory fees the fund managers received from the funds. By this method mutual fund shareholders were able to recapture a substantial part of the commissions paid out, despite the restricted and rigid commission rate structure. The SEC also pointed out that in some cases, income from give-ups and reciprocal business received by the affiliates were not credited to the advisory fees, but were kept by the affiliates without a decrease in the fees. In the majority of cases, however, commissions were not recouped for the benefit of shareholders, but were used to provide additional rewards to independent broker-dealers which distributed fund shares.

According to this release of the SEC, all the practices described above led to (1) a tremendous increase in the volume of trading on regional exchanges; (2) commissions being diverted to non-members of the NYSE, although they performed no function in the execution of orders by NYSE members on the regional exchanges; and (3) a trend whereby excess commissions were being partially returned to mutual funds to the benefit of the shareholders of the funds.

Rule 10b-10 of the SEC, considered a landmark in the securities industry, and by the majority of broker-dealers an infamous one, contained the following statements:

1. It shall be considered unlawful for any registered investment company or affiliated person of such registered investment company directly or indirectly, to order or request any broker or dealer:

(a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person <u>unless</u> pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owned by or charged to such registered investment company are required to be reduced in an amount equal to the remittance;

(b) to designate or employ any broker or dealer on any transaction to transmit, execute or clear a transaction or to perform any other function for which compensation is required or made <u>unless</u> pursuant to a written contract the full amount of such compensation is required to be paid over to such registered investment company or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to such compensation.

2. For the purpose of this rule a person is affiliated with a registered investment company if such person:

(a) is an officer, director trustee, employee, investment adviser, member of an advisory board, depositor, promoter of or principal underwriter for the registered investment company, or

(b) directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with the registered investment company, its investment adviser or principal underwriter, or

(c) directly or indirectly owns, controls, or holds with the power to vote, five per centum or more of the outstanding voting securities of the registered company.[6]

Basically the proposed Rule 10b-10 prohibited give-ups of commissions which were directed by mutual funds, unless all amounts given up were returned to the mutual funds.

The SEC's release concluded with a statement inviting interested persons to submit their opinions on both its proposed rule, and the proposal of the NYSE with any alternative solutions or suggestions for dealing with the give-up and related problems.

Securities Exchange Act Release No. 8324 of May 28, 1968

In this release, the SEC concluded that on the basis of information gathered, the devious practices connected with the current commission rate structure did not provide for fixed minimum charges on a great many exchange transactions. As a result, the SEC requested the NYSE to adopt a provisional revised commission rate schedule which would permit reduced commission charges on the portion of an order involving round lots in excess of 400 shares. As an alternative to this proposal the NYSE could do away with minimum commission rates on orders in excess of $50,000. Other registered exchanges also were requested to

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[6] Security Exchange Act Release No. 8239. Proposed Commission Rule 10b-10 (January 26, 1968), pp. 9-10.

modify their rules relating to commission rates.

Important to note is the fact that the SEC did not order or direct the NYSE and other registered exchanges to change their commission rate schedules. Instead, the word, "request", was used. The following paragraph is a direct quotation from the letter written by Manuel F. Cohen, Chairman of the SEC to Robert W. Haack, President of the NYSE. The date of the letter, May 28, 1969, is identical to the date of SEC Release No. 8324.

> The Commission hereby makes written request pursuant to Section 19(b) of the Securities Exchange Act that your Exchange effect on its own behalf changes, to become effective on or before September 15, 1968, in its rules, policies and practices in respect of its commission rate by modifying Article XV, Section 2(a)(1) and appropriate other sections of the exchange constitutions and rules either (a) in accordance with the revised minimum commission rates as set forth in Attachment A, or alternatively, (b) by eliminating, with respect to orders in excess of $50,000, requirements for minimum rates of commission.[7]

An additional comment made was that the request was based on deficiencies in the present rate structure that did not allow appropriate discounts, but instead permitted give-ups to be directed by mutual fund managers, resulting in deviations from the minimum rate structure in a discriminatory and arbitrary manner. The Chairman of the SEC also informed the President of the NYSE that public hearings would be held, beginning July 1, 1968, to discuss the commission rate structure of registered securities exchanges.

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[7]Independent Broker-Dealers' Trade Association, Oxford Securities, Inc., and James C. Butterfield, Inc., v. Securities and Exchange Commission, No. 22,552, United States Court of Appeals for the District of Columbia Circuit, 31 (1968).

Letter from Robert W. Haack, President of the NYSE, to Manuel F. Cohen, Chairman of the SEC, August 8, 1968

In this letter, Mr. Haack informed Mr. Cohen that on June 28, 1968, the Board of Governors of the NYSE had approved in principle a volume discount, a gradual elimination of the customer-directed give-up over a period of at least one year, and a $33\frac{1}{3}$ per cent discount to bonafide non-member broker-dealers. However, Mr. Haack pointed out that on August 7, 1968, the Board of Governors had reconsidered the issues and had proposed:

> . . . (1) a specific interim non-member commission schedule embodying a reduced rate for volume orders; (2) specific interim intra-member commission schedules embodying across the board reductions; (3) additional language to the Exchange Constitution which would prohibit customer-directed give-ups of work or money in consideration of listed business; and (4) a postponement of consideration of non-member access.[8]

The NYSE-proposed volume discount differed somewhat from that of the SEC. The NYSE suggested that no change in commissions should take place on orders under 1000 shares, compared to 400 under the SEC's proposal. The NYSE further stated that based on the responses of 306 member firms doing about 93 per cent of all securities business on national exchanges, the proposed interim rate schedule of the NYSE would reduce annual commission from securities transactions by approximately $150 million.

On June 28, 1968, the Board of Governors of the NYSE proposed a gradual elimination of the practice of customer-directed

[8] *Ibid.*, p. 36.

give-ups. On further reflection, the Board decided that a gradual elimination would not be suitable, because the intricate and complex arrangements through which customer-directed give-ups took place involved the use of unrelated trades. The Board therefore decided that only a complete prohibition would prevent the flagrant continuation of give-up practices. Finally, the NYSE proposed that both the interim commission schedule and the rule prohibiting customer-directed give-ups should become effective at the same time. Thus, according to the new rule,

> . . . no member, member firm or member corporation shall, in consideration of the receipt of listed business and at the direct or indirect request of a non-member or by direct or indirect arrangement with a non-member, make any payment or give up any work or give up all or any part of any commission or other property to which such member, member firm or member corporation is or will be entitled.[9]

The reason the NYSE gave for postponing the discount to non-member brokers (which in reality would permit limited access to the Exchange), was that the question of institutional membership and non-member access could not be separated. Since both subjects were being discussed at the SEC hearings, it would reach a decision when the hearings were concluded.

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[9] New York Stock Exchange Constitution and Rules (April 15, 1970), Article XV, Section 1, pp. 1091-1094.

Letter from Manuel F. Cohen, Chairman of the SEC, to Robert W. Haack, President of the NYSE, August 30, 1968

In this letter, Mr. Cohen pointed out that the NYSE's proposed amendment to its constitution prohibiting customer-directed give-ups of work or money in consideration of listed business should not interfere with non-customer-directed inter-dealer reciprocal business on regional exchanges, nor should it prevent broker-dealer affiliates of institutions from crediting or returning commissions to institutions with which they were affiliated.

Mr. Cohen further stated that the SEC would accept the proposed interim non-member commission schedule, if the members of the NYSE approved the proposal. If the interim schedule proposed by the Board of Governors of the Exchange was not approved, then the alternative would have to be adoption of the elimination of minimum rates of commission for orders in excess of $50,000.

Mr. Cohen concluded with these final remarks:

> We wish to emphasize that these changes are interim steps. The Commission has reached no conclusion on whether the particular rates embodied in the interim non-member commission schedule reflect the optimum form of rate structure for your Exchange or that any schedule of specific rates would provide a complete answer to the problems raised in Release No. 8239 and the comments thereon. Additional measures with respect to these and other matters are under continuing consideration and will be examined further in the course of our hearings. In directing you to adopt these measures on an interim basis we assume that you will address yourself as promptly as possible to the matter of changes of a permanent nature.[10]

For the first time in letters to the NYSE, the SEC used "direct". This is pointed out because, among firms involved in mutual fund operations, it is a widely-held belief that the New York Stock Exchange was forced by the SEC to prohibit customer-directed give-ups.

The original proposal of the NYSE was to phase out the give-up over a period of time, instead of an abrupt cessation of the practice, which eventually took place. Because of the words "direct" and "direction", the Independent Broker-Dealers' Trade Association, Oxford Securities, Inc., and James C. Butterfield, Inc., filed a law suit against the SEC claiming that Mr. Cohen's letter to Robert W. Haack, President of the NYSE constituted an unlawful order which was in excess of its statutory authority because no opportunity for a hearing was given prior to its release. This procedure is required by section 19(b) of the Securities Exchange Act of 1934. In subsequent chapters, more details of the law suit will be given.

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[10] Independent Broker-Dealers' Trade Association, Oxford Securities, Inc., and James C. Butterfield, Inc., v. Securities and Exchange Commission, No. 22,552, United States Court of Appeals for the District of Columbia Circuit, 53 (1968).

Securities Exchange Act Release No. 8399 of September 4, 1968, and Letter from Irving M. Pollack, Director of the Division of Trading and Markets of the SEC to Robert W. Haack, September 4, 1968

Release No. 8399 pointed out that because of problems beyond the control of the NYSE, the SEC had agreed to modify its original request for the institution of the interim commission rate schedule. The date would be moved from September 15, 1968 to one not later than December 5, 1968.

Mr. Pollack pointed out in his letter of September 4, 1968, that for the new proposals to be equitable to all parties, there should be uniform application of the abolition of customer-directed give-ups on all exchanges. He further stated that the other exchanges would probably want to effect changes to remain competitive with the NYSE new commission schedule. Mr. Pollack went on to say that from evidence developed at the rate structure hearings,

> . . . any purported change in rate structure, other than the adoption of a provision for freely negotiated rates would be a sham, unless there was evidence that it was to be realistically adhered to by inclusion of appropriate provisions for abolition of customer-directed give-ups. While any exchange would of course, be free to argue to the contrary, we believe that the Commission's policy on abolition of give-ups has already been clearly expressed.[11]

Obviously, from the tone of the letter, the SEC certainly expected the regional exchanges to abolish or prohibit customer-directed give-ups if they wished to adopt a volume discount to remain competitive with the NYSE.

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[11] *Ibid.*, p. 54.

Special Membership Bulletin from the NYSE to its Members on the Proposed Amendment of Article XV, October 10, 1968

Members were informed that the Board of Governors had approved the proposed amendment to Article XV of the Exchange's Constitution, which called for a prohibition of customer-directed give-ups, a volume discount for portions of large orders over 1,000 shares, and a reduction in intra-member rates. The bulletin specified that the amendment was necessary for the preservation of the minimum commission structure, as it would eliminate abusive practices which had caused leakages in commissions. Legally reduced commission rates would remove much of the pressure to obtain them in a circuitous manner; the abolition of give-ups would eliminate the means for doing so.

The institution of the volume discount proposed by the NYSE would result in an annual reduction in gross commission of about $150 million compared to approximately $180 million if the commission schedule proposed by the SEC had been adopted.

The Board of Governors of the NYSE felt that it would be unreasonable to permit or defend give-up devices and simultaneously justify the retention of minimum commissions. For this reason, the abolition of customer-directed give-ups was made an integral part of the revised commission rate structure, although the SEC in its statement of May 28, 1968 did not specifically request the abolition of the give-up.

The NYSE would not eliminate the traditional non-customer directed inter-dealer reciprocal business on regional exchanges, but only give-ups of money or work directed by a non-member. In addition, the prohibition would not preclude broker-dealers who were affiliated with institutions from crediting commissions to the affiliated institutions.

Miscellaneous Correspondence and Bulletins

On October 11, 1968 the Securities and Exchange Commission was requested by legal counsel for the Independent Broker-Dealers' Trade Association to set aside its request of August 30, 1968, to the NYSE relating to the revised commission structure and rates. The legal counsel for the appellants also requested the SEC to instruct the NYSE not to count ballots or take any other action to implement any changes in its commissions structure.

The SEC replied to Shipley, Ackerman and Pickett, legal counsel for the IBDTA, on October 18. The SEC stated it had decided to deny all requests of Shipley, Ackerman and Pickett since there had been no commission action appropriate for judicial review. In addition, the SEC stated it had no control over voting or balloting on the NYSE.

On October 25, 1968, in a special membership bulletin, the NYSE announced that by a membership vote of 925 to 266, Article XV of the Constitution had been amended to include the new interim commission rate schedule which would become effective

December 5 of the same year. The prohibition of customer-directed give-ups would be an integral part of the interim schedule. The special bulletin emphasized that the future of the minimum commission could well depend on the success of the interim schedule.

On December 5, 1968, the customer-directed give-up became illegal. The volume discount proposed by the NYSE became effective on the same date. Ironically, December, 1968 marked the beginning of the worst bear market of recent times. The sequence of events leading to the prohibition of the customer-directed give-up has been related in the previous pages. The two main protagonists in these events were the SEC and the NYSE. The views of the United States Department of Justice on give-ups and the NYSE commission rate structure were not reviewed, although it is a foregone conclusion that fear of intervention by the Department of Justice prompted the NYSE to alter its original proposal on elimination of give-ups. In Part IV the legality and ethical overtones of prohibiting give-ups will be discussed, and the views of the Department of Justice are presented in that section.

PART II

THE IMPACT OF THE ABOLITION OF CUSTOMER-DIRECTED GIVE-UPS ON MUTUAL FUND RETAILERS

PART II

THE IMPACT OF THE ABOLITION OF CUSTOMER-DIRECTED GIVE-UPS ON MUTUAL FUND RETAILERS

When reforms in the management of open-end investment companies (mutual funds) and in the distribution of fund shares were first proposed by the Securities and Exchange Commission, among those who strongly objected to the proposals was the National Association of Securities Dealers, Inc. In 1938, the passage of the Maloney Amendment to the Securities Acts of 1933 and 1934, empowered the Securities and Exchange Commission to supervise the formation and functioning of associations created for the purpose of regulating the conduct of over-the-counter trading. Consequently, the National Association of Securities Dealers was formed in 1939. It is a nonprofit organization which establishes and enforces fair rules of business conduct for its members and promotes ethical trade practices. Any broker or dealer engaged in the investment banking business is eligible for membership, provided he can meet the moral and ethical requirements of the Association.

In 1967, the National Association of Securities Dealers published a report entitled, "ECONOMIC CONSEQUENCES FOR THE SECURITIES BUSINESS of Proposals of the Securities and Exchange Commission in its Report to Congress Entitled 'Public Policy

Implications of Investment Company Growth' ". Part II of this dissertation will review this study and the conclusions reached by the National Association of Securities Dealers.

In addition, Part II will also review the results of a questionnaire survey made by the Independent Broker-Dealers' Trade Association in the latter part of 1969. The Independent Broker-Dealers' Trade Association, a nonprofit trade association, was formed in late 1966 "to protect and assert the rights and interests of independent brokers and dealers who are not members of the New York Stock Exchange."[1] At present, the Independent Broker-Dealers' Trade Association has approximately 400 members and any of the more than 3000 registered brokers and dealers in America who are non-members of the New York Stock Exchange are eligible for membership.

The studies of both the National Association of Securities Dealers and the Independent Broker-Dealers' Trade Association related not only to the ban of the customer-directed give-up, but to total mutual fund reform proposals which include (1) reduction of the sales charge on mutual fund shares; (2) elimination of the front-end load on periodic payment contractual plans; and (3) elimination of the sales charge on reinvestment of income dividends. Only the results of these studies in relation to the give-up problem will be discussed in this section.

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[1]The Independent Broker-Dealers' Trade Association, First Annual Report (1969), p. 1.

Finally, Part II of this dissertation will review in detail the results of the questionnaire study carried out by the author to determine how the ban of customer-directed give-ups has affected retailers of mutual funds. This study is related solely to the commission-splitting or give-up problem, and is not an attempt to determine the effects of total mutual fund reform proposals.

CHAPTER IV

REVIEW OF THE STUDIES BY THE NATIONAL ASSOCIATION OF SECURITIES DEALERS AND THE INDEPENDENT BROKER-DEALERS' TRADE ASSOCIATION

The Design and Selection of the National Association of Securities Dealers' Sample Questionnaire

In January of 1967, the Board of Governors of the National Association of Securities Dealers, alarmed at the mutual fund reform proposals of the Securities and Exchange Commission, authorized a study to determine the probable economic consequences of the Commission's proposals. Booz-Allen Applied Research, Inc. of Washington was selected to assist the National Association of Securities Dealers in the preparation, processing and analysis of the questionnaires.

The following statement describes the method employed by Booz-Allen Applied Research, Inc. to design and select the sample:

> The first step in designing and selecting a sample of NASD member firms to be surveyed was to stratify (or array) the 2,479 firms which responded to Questionnaire 1 of the Over-the-Counter Market Study (prepared for the NASD by Booz-Allen & Hamilton, Inc., August 1966) in a cross classification by (a) total gross income, and (b) ratio of mutual fund income to total gross income. In both cases the 1964 reported income figures were used. Next, those firms reporting no mutual fund income were deleted from the universe. The remaining 1,826 firms fell into 24 cells of the cross classification which constituted the universe from which the sample was selected. Based upon the estimated degree of variability of results and upon the degree of reliability sought, it was determined that a ten per cent sample would be more than

adequate. This provided 181 names, to which were added an additional selected 14 firms to broaden the sample in areas where it appeared to be deficient in number and to provide a control group. Questionnaires were directed to these 195 firms, and were returned by 185. In accordance with NASD instructions, Booz-Allen Applied Research, Inc. applied standard statistical tests of reliability and significance to many of the results cited in this report. These support the validity of the conclusions stated.[2]

Conclusions of the Study

Based on the findings of the study the National Association of Securities Dealers stated that its members

> . . . will suffer a significant loss of income and a great many firms would be forced to leave the business should the proposals of the Securities and Exchange Commission, legislative and otherwise, relating to open-end investment companies (mutual funds), actually take effect. Moreover, it appears that there could be so significant a reduction in the probability of the comparatively small sale that large numbers of potential investors may no longer have this important investment medium brought to their attention.[3]

The conclusions of the preceding paragraph referred to the effect of all recommendations of the Securities and Exchange Commission. With regard to the elimination of give-ups, the National Association of Securities Dealers maintained that

> . . . in the aggregate for the 185 firms included in the sample, elimination of give-ups in 1966 would have resulted in an increase in net income after tax, because thirteen of the largest firms in the sample paid out by way of give-ups considerably more in total than they received from that

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[2] The National Association of Securities Dealers, Inc., Economic Consequences for the Securities Business of Proposals of the Securities and Exchange Commission in its Report to Congress Entitled "Public Policy Implications of Investment Company Growth" (April 1967), pp. 48-49.

[3] Ibid., p. 1.

> source. The other 172 would have suffered a loss. For all registered broker-dealers in the aggregate, payments of give-ups would equal receipts from give-ups in any particular time period; thus elimination of give-ups for all would leave unchanged the aggregate net income after tax for the industry, while simultaneously changing substantially the profits within the industry, in effect shifting profits from the smaller and medium size firms to the largest firms.[4]

According to the study, give-ups in 1966 amounted to more than 98 per cent of the net income of the smallest income class of the firms sampled, and exceeded by over 100 per cent the total net income of the next largest class ($100,000 - $200,000). This statement is somewhat confusing, but a review of Table 15 shows that the sample firms with gross incomes under $100,000 received $119,000 in give-ups. Since this amount represented 98.3 per cent of their net income, this meant that the net income for this group of firms was approximately $121,000. Firms in the gross income category of $100,000 - $200,000 received $94,000 in give-ups; if $94,000 amounted to 209 per cent of their net income, then the net income for the group must have been approximately $45,000. For further clarification, the sample income statement illustrates how the NASD probably arrived at the figure of 209 per cent:

Operating income	$ (4,000)
Income from give-ups	94,000
Net income before taxes	$ 90,000
Tax (50 per cent rate)	45,000
Net income after taxes	$ 45,000

$$\frac{\$\ 94{,}000}{\$\ 45{,}000} = 209 \text{ per cent}$$

[4] *Ibid.*, p. 6.

TABLE 15

CUSTOMER-DIRECTED GIVE-UPS PAID AND RECEIVED BY SAMPLE FIRMS IN THE NASD STUDY

Gross Income of Firms (Thousands of Dollars)		Give-ups Received			Give-ups Paid		
		Thousands of Dollars	Per Cent of Net Income	Per Cent of Give-ups	Thousands of Dollars	Per Cent of Net Income	Per Cent of Give-ups
Over $2,500	(26)	5,017	35.4	81.1	7,472	52.8	98.1
$200 - $2,500	(41)	960	58.0	15.5	151	9.1	1.9
$100 - $200	(17)	94	209.0	1.5	0	0.0	0.0
Under $100	(101)	119	98.3	1.9	0	0.0	0.0
Total	(185)	6,190		100.0	7,623		100.0

Source: National Association of Securities Dealers. Economic Consequences for the Securities Business of Proposals of the Securities and Exchange Commission in its Report to Congress Entitled "Public Policy Implications of Investment Company Growth," April 1967, p. 31.

Notes:

The 185 firms sampled by the NASD received $6,190,000 in give-ups while paying out $7,623,000 in give-ups. Thus, these firms paid out approximately $1,433,000 more than they received.

Figures in parentheses represent the number of firms in the sample.

The National Association of Securities Dealers noted that since virtually no business expense is allocable to the receipt of this kind of revenue, any loss of give-up revenue may be expected to be directly reflected in reduced net profits of the receiving firms. A review of Table 15 also shows that firms with gross income in 1966 exceeding $2,500,000 received 81.1 per cent of customer-directed give-ups; these same firms accounted for 98.1 per cent of all give-ups paid by the firms sampled.

Table 16 shows how 1966 net income of the sample firms would have been affected by the elimination of give-ups. According to the NASD study, firms in the $100,000 - $200,000 gross income category would have been most affected. This group of firms would have lost 149 per cent of 1966 net income, and more than half would have had deficits for the year.

While there is an increase in net income for the whole group because of the elimination of give-ups, only firms in the largest income group would have benefited from the increase. The National Association of Securities Dealers states that

> . . . detailed analysis of the sample shows that 13 firms of the 185 would have realized gains. This group of 13 includes the seven largest firms in the sample, each of which had gross income in 1966 in excess of $14 millions; nine of the firms that would have gained are among the 10 largest in the sample; and all had gross incomes in 1966 in excess of $300,000. As would be expected, each of the 13 is a member of at least one securities exchange and 12 of the 13 are members of the New York Stock Exchange and other exchanges. When the 13 exceptionally large firms that would realize a gain are excluded from the sample, the remaining 172 firms would have suffered a loss in excess of $1.5 millions, or

TABLE 16

THE EFFECT OF ELIMINATION OF CUSTOMER-DIRECTED GIVE-UPS ON 1966 NET AFTER TAX INCOME OF FIRMS IN THE NASD STUDY

Gross Income of Firms (Thousands of Dollars)	Number of Firms	Net Income After Taxes (Thousands of Dollars)			Percentage Change
		Before Elimination	After Elimination	Amount of Change	
Over $2,500	26	14,160	16,040	1,880	13.4*
$200 - $2,500	41	1,655	1,253	(402)	(24.3)
$100 - $200	17	45	(22)	(67)	(149.0)
Under $100	101	121	33	(88)	(72.7)
Total	185	15,981	17,304	1,323	8.2

Source: National Association of Securities Dealers. Economic Consequences for the Securities Business of Proposals of the Securities and Exchange Commission in its Report to Congress Entitled "Public Policy Implications of Investment Company Growth," April 1967, p. 33.

*Since firms with gross income of over $2,500,000 paid substantially more in give-ups than they received, it follows that eliminating give-ups would benefit these firms, with a resulting increase in net income.

about 31.6 per cent of their 1966 net income after taxes.[5] The section of the study on the elimination of give-ups concludes with a statement that the result of abolishing customer-directed give-ups would be to concentrate the substantial income from that source in the hands of a few of the largest firms in the business, while seriously reducing the profitability of many of the remaining firms.

Evaluation and Criticism of the National Association of Securities Dealers' Study

In reviewing the study of the National Association of Securities Dealers, the question arises as to why a regulatory body sponsored a study, the conclusions of which were directly opposite to those of another more powerful regulatory organization, the Securities and Exchange Commission. The passage of the Maloney Amendment to the Securities Acts of 1933 and 1934, empowered the Securities and Exchange Commission to supervise the formation and functioning of associations formed for the purpose of regulating the conduct of over-the-counter trading. While it may not be correct to state that the Securities and Exchange Commission is the parent organization of the National Association of Securities Dealers, it does play an important role in the functions of the Association. For example, an applicant who has been refused membership to the National Association of Securities

[5] *Ibid.*, p. 32.

Dealers may appeal to the Securities and Exchange Commission, and have his appeal upheld.

Why then did the National Association of Securities Dealers authorize the study? Was it an act of rebellion against the Securities and Exchange Commission? Was it forced on the Association by its members? Or did the National Association of Securities Dealers genuinely believe that abolition of traditional give-up practices would jeopardize the existence of its members, and consequently also jeopardize the existence of the Association? The National Association of Securities Dealers cannot exist without broker-dealer members. Possibly the major reason for the study was neither an act of rebellion against the Securities and Exchange Commission, nor a genuine concern for the welfare of the members of the National Association of Securities Dealers; rather it may have been done purely to placate its members who were angry and disgusted at the proposed reforms of the Securities and Exchange, and who also believed very strongly that their interests were not being adequately protected by the National Association of Securities Dealers.

In gathering data for this dissertation, the author interviewed many broker-dealers. In these interviews one unanimous complaint arose--the broker-dealers believed that they were not being properly represented by the National Association of Securities Dealers. In the Securities Industry Questionnaire for Non-NYSE Members carried out by the Independent Broker-Dealers'

Trade Association,[6] one of the questions asked was, "Do you feel the NASD is anti-small business?" Of the 189 replies--114 answered yes, 47 answered no, and 28 were undecided. To the question, "Do you feel the SEC is anti-small business?"--156 answered yes, 20 answered no, and 13 were undecided. The answer to the SEC question could be expected since the majority of businessmen do not particularly care for government intervention or control, but it appears rather tragic that members of an organization consider it detrimental to their own interests.

If members are dissatisfied with the policies of the National Association of Securities Dealers, why do they not resign? Why bother to join the Association? The answer is quite simple. Broker-dealers really have little choice; they either join or find themselves barred from many preferential business advantages. A recent article in the Wall Street Journal points out that the National Association of Securities Dealers encourages broker-dealers to join the Association by offering preferential business advantages.

> Probably the major inducement of the rule is a section that bars NASD members from participating with nonmember broker-dealers in any distribution of securities to the public. Thus, NASD membership is a prerequisite to receiving lucrative underwriting fees and the price discounts that NASD members get for selling mutual fund shares to the public. The NASD won't permit the shares of a mutual fund

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[6] The Independent Broker-Dealers' Trade Association, Securities Industry Questionnaire for Non-NYSE Members (December 1969), p. 1.

> underwritten by an NASD member to be sold by nonmember broker-dealers. Neither will it permit the shares of a mutual fund underwritten by a non-NASD broker-dealer to be sold by NASD broker-dealers.[7]

Worth noting is the disagreement between the Securities and Exchange Commission and the National Association of Securities Dealers. The SEC states that the NASD cannot prohibit its members from receiving price discounts.

As was previously noted, the study of the NASD was published in April of 1967. In its 1967 annual report, the president of the NASD said that

> . . . we are strongly opposed to the 10b-10 rule on the basis that traditional give-up practices of the investment business are an integral part of the distribution system for mutual funds, providing the most efficient procedure for the execution of relatively large orders placed by investment companies. Any restriction that would prohibit present give-up practices could seriously disrupt the complex distribution pattern for mutual funds and also fractionalize the handling of large investment portfolio transactions to the detriment of shareholders in a fund.[8]

In 1968, according to NASD members interviewed by the author, a confrontation took place between the Securities and Exchange Commission and the National Association of Securities Dealers over the study of the NASD and its stand against mutual fund reforms, particularly the elimination of the customer-directed

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[7] The Wall Street Journal, Legal Test Looms for NASD Regulation Covering Securities Distribution (April 28, 1970), p. 2.

[8] The National Association of Securities Dealers, Inc., Annual Report to Members (1967), p. 22.

give-up. The NASD was censured for acting as a trade association instead of a quasi-governmental regulatory body. Chastened and subdued, the NASD decided to stop its attacks on the proposed mutual fund reforms, and instead adopted a new ploy to placate its members. This was the limited access rule to the New York Stock Exchange, whereby nonmembers would receive a $33\frac{1}{3}$ per cent commission discount on orders executed. Naturally, the new stand taken by the National Association of Securities Dealers did not meet with member approval. In the survey taken by the Independent Broker-Dealers' Trade Association, the following question was asked: "Do you feel the proposed $33\frac{1}{3}$ per cent commission access to the New York Stock Exchange for nonmembers is adequate?" Of those replying--137 said no, 36 answered yes, and 16 were noncommittal. On the average, those who felt the proposed commission discount was inadequate suggested a figure of approximately 50 per cent.[9] The author agrees with the opinion of these individuals since a nonmember of the major or regional exchanges in most instances can execute trades on the Third Market at rates more advantageous than the one proposed above.

On page 16 of the 1967 NASD Report to Members, there is a statement that at year end the membership numbered 3669. On page two of the NASD report entitled Economic Consequences for the

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[9]The Independent Broker-Dealers' Trade Association, Securities Industry Questionnaire for Non-NYSE Members (December 1969), p. 3.

Securities Business, the report states that some 3,600 NASD broker-dealers employ about 90,000 salesmen, nearly all of whom, at some time or other, sell mutual fund shares to their customers. With more than 3600 broker-dealers involved in mutual fund sales, one wonders why the sample for the NASD study was selected from only a population of 1826 firms, which constituted approximately 50 per cent of mutual fund retailers in 1967.

When the NASD published the results of its study, the Securities and Exchange Commission was somewhat skeptical of the findings. The Commission requested the NASD to hand over its records, since the SEC wished to verify the results. The NASD was unable to provide the SEC with any of the data collected for the study, since the data had been destroyed by Booz-Allen Applied Research, Inc. Presumably the data had been destroyed to protect the identities of the respondents.

Tables 15 and 16 which were prepared from statistics contained in the NASD report, are somewhat confusing and definitely misleading. For example, Table 15 shows that the 101 firms, each with gross income less than $100,000, received a total of $119,000 in give-ups, which amounted to 98.3 per cent of total net income. What these tables imply is that each and every firm received give-ups. In no part of the NASD report is the fact mentioned that many many firms never received a dollar of give-ups. The reason was simply because the volume of their mutual fund sales did not justify give-ups being directed to them by mutual funds.

According to Mr. Raymond W. Cocchi, President of the Independent Broker-Dealers' Trade Association, only the firms who were large retailers of mutual funds received give-ups which amounted to a significant amount of dollars. In his opinion, a large retailer of mutual funds would be one selling approximately $10,000,000 of a particular fund. The sales charge or the dealers' commission on these sales would be approximately six per cent; thus the dealers' gross income on sales of $10,000,000 would be approximately $600,000.[10] The point to be made here is that the average broker-dealer with a gross income under $100,000 probably received no income from customer-directed give-up, or an amount which would be insignificant in relation to his total gross income. If the elimination of an insignificant amount of income was sufficient to change the average dealer from a position of profit to one of loss, how efficiently could the operations of the average dealer have been in the first place?

On page 30 of its report, the NASD stated that

> . . . since there is virtually no business expense allocable to the receipt of this kind of revenue, any loss of give-up income may be expected to be directly reflected in reduced net profits of the receiving firms. In many cases, the reduction would throw individual firms into loss positions.[11]

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[10] Raymond W. Cocchi, President of the Independent Broker-Dealers' Trade Association, Springfield, Massachusetts, July 1970.

[11] The National Association of Securities Dealers, Inc., <u>Economic Consequences for the Securities Business of Proposals of the Securities and Exchange Commission in its Report to Congress Entitled "Public Policy Implications of Investment Company Growth"</u> (April 1967), p. 30.

This statement is debatable since some business expenses are allocable to give-up revenue. Mutual funds directed give-ups to firms selling their fund shares, not because of unbounded generosity or because of their altruistic natures, but simply because the mutual fund retailers were providing needed research for the mutual funds or extra services to the buyers of mutual fund shares. The time spent on research by the mutual fund retailers must have had a cost; the extra time spent servicing the accounts of mutual fund buyers must have resulted in time spent which could probably have been utilized in procuring new sales. The results of the author's survey which will be presented in the next chapter show that mutual fund retailers did allocate costs to give-up revenue and have reduced these costs to compensate for any loss they may have suffered through the elimination of customer-directed give-ups.

Review of the Study of the Independent Broker-Dealers' Trade Association

In the latter part of 1969 a survey entitled "Securities Industry Questionnaire for Non-NYSE Members" was prepared by the Independent Broker-Dealers' Trade Association. According to Mr. Raymond W. Cocchi, President of the Association, the

> . . . survey was prompted by members of Congress who have expressed deep concern over the continued profitability of independent brokers and dealers, particularly in the face of loss of give-ups, pending Mutual Fund Legislation, and rising costs in maintaining small businesses.[12]

This study was not a sophisticated one, and according to Mr. Cocchi it was conceived on a plane trip back to Springfield, Massachusetts, the headquarters of the Association. Questionnaires were sent to approximately 400 of the Trade Association members and replies were received from 189 members, or a little less than 50 per cent. Second requests were not sent to the non-respondents. The following questions were asked about give-ups:

<u>Question</u>: Did your firm receive "give-ups" or "reciprocal" from Mutual Funds prior to December 5, 1968?

<u>Replies</u>: Yes, 166; No, 17; Non-committal, 6

<u>Question</u>: Approximately what percentage of "give-ups" or "reciprocal" did you receive in relation to your Mutual Fund sales?

<u>Replies</u>: Average 1.44 per cent

<u>Question</u>: Have you received "give-ups" or "reciprocal" since December 5, 1968?

<u>Replies</u>: Yes, 23; No, 160; Non-committal, 3

Presumably the "reciprocal" in the questions refers to orders for sales or purchase of securities given to the firms by mutual funds. This is a perfectly legitimate practice.

IBDTA members were also asked for their opinions of the SEC and the NASD.

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[12] The Independent Broker-Dealers' Trade Association, <u>Securities Industry Questionnaire for Non-NYSE Members</u> (December 1969), p. 1.

<u>Question</u>: Do you feel the SEC is anti-small business?

<u>Replies</u>: Yes, 156; No, 20; Non-committal, 13

<u>Question</u>: Do you feel the NASD is anti-small business?

<u>Replies</u>: Yes, 114; No, 47; Non-committal, 28

<u>Question</u>: Do you feel like part of the industry? That is, are you posted on the effects of new regulations and new legislation prior to their enactment?

<u>Replies</u>: Yes, 74; No, 106; Non-committal, 9

The general opinion of the respondents was that both the SEC and the NASD were anti-small business. A majority of broker-dealers also felt that they should be informed of the possible effects of new regulations and legislation before the regulations and legislation became effective.

CHAPTER V

A QUESTIONNAIRE SURVEY TO DETERMINE THE IMPACT ON INCOME OF MUTUAL FUND RETAILERS DUE TO THE ABOLITION OF CUSTOMER-DIRECTED GIVE-UPS

Chapter V is devoted to the questionnaire survey carried out by the author of this dissertation. The purpose of the study was stated in detail in Part I. One of the main reasons for the study was to determine if a significant redistribution had taken place during 1969 in (1) gross income of mutual fund retailers; and (2) in income from mutual fund operations as a per cent of gross income. Another reason for the questionnaire was to ascertain what changes had taken place in the organization structure and operations of firms that may have been affected by the elimination of customer-directed give-ups.

Chapter V deals with the following topics: (1) the design and the selection of the sample; (2) questionnaire mailings; (3) statistical tests performed; (4) analysis of the collected data; (5) selected comments by the respondents; and (6) the author's conclusions on the survey.

The purpose of the questionnaire was not to try to prove or disprove the assertions of the National Association of Securities Dealers and broker-dealers that the elimination of give-ups would result in tragic consequences for many firms.

Neither was it an attempt to justify the actions of the Securities and Exchange Commission and the New York Stock Exchange. Instead, it should be considered purely an effort to determine the results, beneficial or detrimental, of legislation which had created a considerable amount of furor in the securities industry.

The Design and Selection of the Sample Questionnaire

Considerable time was spent interviewing broker-dealers to discuss the format of the questionnaire. The advice of the National Association of Securities Dealers and the Securities and Exchange Commission was also enlisted. On the advice of all parties, a decision was made not to ask for specific dollar income figures, but rather to obtain percentage figures. In addition, to insure complete confidence that replies would not be unethically used, the names of the respondents were not requested. The belief was held that the response would be greater if the survey was kept as confidential as possible. The final format incorporated suggestions of the broker-dealers, the NASD, the SEC, and the members of the candidate's committee.

A considerable problem developed in obtaining population data from which to draw a sample. The SEC very kindly consented to allow the author to use its computer listings of broker-dealers who had registered with the SEC. These listings contained firms which at the time of registration indicated that mutual fund sales either accounted for, or would account for, ten per cent or more of annual gross income. The total number of firms on the SEC's list amounted to 3115. Of this amount, however, 327 were not coded as having ten per cent or more of annual gross income from the retailing of mutual funds. Possibly some of the 327 firms may have sold mutual fund shares, although the coding indicated that a great many were primarily concerned with selling variable annuities or in mutual fund underwriting. Since it was not possible to indicate the extent of their mutual fund retail operations, they were deleted from the population to be sampled. This deletion left a group of 2788 firms which, at the time of registration, indicated that the retailing of mutual fund shares would contribute ten per cent or more to total annual gross income. Three points should be noted here: (1) although at the time of registration mutual fund sales were expected to contribute ten per cent or more to gross income, expectations may not have materialized; (2) the dates of registration were at different times--for example, it is possible for a firm to have registered in 1950 and to have done more than a ten per cent gross in mutual fund sales at that time, but in 1969 the same firm's share of mutual fund income could have been less than ten per cent; and (3) the list contained firms which, for many reasons, were inactive. The author discussed this problem with the SEC and was told that many broker-dealers were indeed inactive but had not informed the SEC and thus were still included on the computer listings.

Standard deviations of the gross income of the firms or standard deviations of income from mutual fund operations as a per cent of gross income were not available. Since time and cost factors did not permit a small sample study to obtain these figures, a decision was made:

1. To use the standard error formula as the determinant of sample size.
2. To be ultraconservative and to set p (the percentage of the sample possessing the given attribute) equal to 0.5 which is its highest possible value.
3. To use a confidence limit of 99 per cent.
4. To have an error limit (or tolerance specification) of + or - 5 per cent. If this level were any lower, with a confidence limit of 99 per cent, the sample size would be abnormally large. For example, with an error limit of 2.5 per cent the sample size would be approximately 2660, almost the total population.
5. To modify the formula for the standard error of a percentage, since the sample constituted a large portion of the population--approximately 20 per cent.
6. To use an unrestricted sample, that is, the sample members would be selected from the population at large; and to choose the sample by systematic selection.

The precision of the sample estimate was to be within +

or - 5 per cent with a 99 per cent reliability. This precision means that when a sample of size n is selected, and the estimate $\bar{x}$ equal to 0.5 is found, this $\bar{x}$ equal to 0.5 is to be within + or - 5 per cent of the population mean with a reliability of 99 per cent.

The Questionnaire Mailings

Table 17 which follows shows the response to the first and second mailings.

On the first mailing, 256 firms replied out of a total of 540 questionnaires mailed; the response was approximately 47 per cent. The 222 questionnaires which were complete in information amounted to approximately 41 per cent of the total number mailed.

Of those replying, approximately 120 indicated their names, although this information was not requested. This reporting meant their names could be deleted from the second mailing request, which amounted to approximately 420 questionnaires. The 420 questionnaires included 136 firms which had replied to the first request but whose identities were unknown. For calculation purposes one must consider the second request as 284 (420 - 136) questionnaires.

There were 86 replies to the second mailing, which amounted to a 30 per cent response. Of the 86 replies, 64 (or 23 per cent of the total) were usable. In total, 540 questionnaires were mailed out and 343 or approximately 64 per cent were returned; of this amount, 286 or approximately 53 per cent were totally usable.

TABLE 17

RESPONSES TO THE FIRST AND SECOND QUESTIONNAIRE MAILINGS

	Usable	Incomplete Information	No Mutual Fund Business	Inactive	Total
First Mailing	222	19	7	8	256
Second Mailing	64	11	4	8	87
Total	286	30	11	16	343

Note:
In addition, 9 letters could not be delivered because of incorrect addresses; 8 were also received confirming they had already replied.

In order to avoid duplication of replies, the following steps were taken: (1) firms were requested not to answer the second questionnaire if they had replied to the first; and (2) a record of the replies were kept by State, which could be determined from the postmark on the envelope; these were checked against the master list of questionnaires mailed, to determine that no more replies were received from a particular State than were mailed to that State. While some duplication in the returns is possible, there is no evidence that such duplication exists, nor does the possibility appear to be great.

Statistical Tests Performed

Statistical tests were performed to determine: (1) whether the responses to the first and second questionnaire mailings came from the same population; (2) whether there was a significant change between 1968 and 1969 in (a) income from mutual fund operations as a per cent of gross income for the two complete samples, and (b) gross income of the two complete samples; and (3) whether gross income of the sample firms was independent of income from mutual fund operations as a per cent of gross income.

1. To determine whether the two sample responses came from the same population, the Test of Homogeneity, one application of the Chi-Square Distribution was used. The null hypothesis for all tests in sections 1(a) and 1(b) is that the two samples came from the same population. The tests were applied to:

(a) Income from mutual fund operations as a per cent of gross income for 1968 and 1969. The results of the tests were as follows:

1968

The x^2 value is 4.45

Present are $(r-1)(s-1) = (6-1)(2-1) = 5$ degrees of freedom

For a 5 per cent level of significance,

$P\ (11.07 < x^2 < \infty) = 0.05$

The rejection region is $x^2 \geq 11.07$

Since x^2 is equal to 4.45, the null hypothesis that both samples came from the same population is accepted.

<u>1969</u>

The x^2 value is 1.17

Present are $(r-1)(s-1) = (6-1)(2-1) = 5$ degrees of freedom

For a 5 per cent level of significance,

$$P\ (11.07 < x^2 < \infty) = 0.05$$

The rejection region is $x^2 \geq 11.07$

Since x^2 is equal to 1.17, the null hypothesis that both samples came from the same population is accepted.

(b) Gross income for 1968 and 1969. The results of the tests were as follows:

<u>1968</u>

The x^2 value is 8.91

Present are $(r-1)(s-1) = (10-1)(2-1) = 9$ degrees of freedom

For a 5 per cent level of significance,

$$P\ (16.92 < x^2 < \infty) = 0.05$$

The rejection region is $x^2 \geq 16.92$

Since x^2 is equal to 8.91, the null hypothesis that both samples came from the same population is accepted.

<u>1969</u>

The x^2 value is 8.68

Present are (r-1)(s-1) = (10-1)(2-1) = 9 degrees of freedom

For a 5 per cent level of significance,

$P\ (16.92 < x^2 < \infty) = 0.05$

The rejection region is $x^2 \geq 16.92$

Since x^2 is equal to 8.68, the null hypothesis that both samples came from the same population is accepted.

2. To determine whether there had been a significant change between 1968 and 1969 in the distribution of (a) income from mutual fund operations as a per cent of gross income, and (b) gross income, both the Test of Homogeneity and the t Distribution were used. For tests (a) and (b) in section 1, responses to the first questionnaire mailing were compared with responses to the second questionnaire mailing to determine if the responses were slightly different. Separate tests were performed for individual years, that is, for 1968 and 1969. For the tests in sections 2 and 3, total responses to both questionnaire mailings were used. To further clarify this point, information in the aggregate for 1968 was tested against similar information for 1969.

The last class of the distribution of gross income was open; this class was for more than $2,500,000. To use the t Test under this condition was impossible, since the standard deviation could not be obtained. An adjustment of the open class was necessary. Three class intervals were estimated: These were \$2,500,000 - \$10,000,000; \$2,500,000 - \$5,000,000; and \$2,500,000 - \$3,500,000. This circumstance was the reason why three separate t Tests were performed in section 2(b).

(a) Test of Homogeneity

Income from mutual fund operations as a per cent of gross income for 1968 and 1969.

The null hypothesis is that there is no difference between the distributions for 1968 and 1969.

The x^2 value is 3.10

Present are $(r-1)(s-1) = (6-1)(2-1) = 5$ degrees of freedom

For a 5 per cent level of significance,

$P\ (11.07 < x^2 < \infty) = 0.05$

The rejection region is $x^2 \geq 11.07$

Since x^2 is equal to 3.10, the null hypothesis is accepted; the distribution of income from mutual fund operations as a per cent of gross income is not significantly different for the years 1968 and 1969.

t Test

The null hypothesis is that there is no difference in the distribution of income for the years 1968 and 1969.

Null hypothesis $H_1 : u_1 = u_2$

Alternative hypothesis $H_2 : u_1 \neq u_2$

$z = 1.15$

For a two tail test, the results are significant at a .05 level if z lies outside the range -1.96 to 1.96, and at a .01 level if z lies outside the range -2.58 to 2.58.

Since z = 1.15, the conclusion is that no significant difference exists in the distribution of mutual fund income as a per cent of gross income for the years 1968 and 1969; the null hypothesis is therefore accepted.

(b) Test of Homogeneity

Gross income for 1968 and 1969.

The null hypothesis is that there is no difference between the distribution for 1968 and 1969.

The x^2 value is 3.58

There are (r-1)(s-1) = (10-1)(2-1) = 9 degrees of freedom

For a 5 per cent level of significance,

$P\ (16.92 < x^2 < \infty) = 0.05$

The rejection region is $x^2 \geq 16.92$

Since x^2 is equal to 3.58, the conclusion is that the distribution of gross income in 1968 does not differ significantly from that of 1969; the hypothesis is therefore accepted.

<u>t Test</u>

i) The null hypothesis is that there is no difference in the distribution of gross income between 1968 and 1969.

Null hypothesis $H_1 : u_1 = u_2$

Alternative hypothesis $H_2 : u_1 \neq u_2$

Using a last class interval of

$2,500,000 - $10,000,000, $z = 0.22$

At both the 0.05 and 0.01 levels of significance, no significant difference exists in the distribution of gross income between 1968 and 1969; the null hypothesis is therefore accepted.

ii) Using a last class interval of

$2,500,000 - $5,000,000, $z = 0.24$

Again the conclusion is that at both the 0.05 and 0.01 levels, no significant difference exists in the distribution of gross income between 1968 and 1969; the null hypothesis is therefore accepted.

iii) Using a last class interval of

$2,500,000 - $3,500,000, $z = 0.25$

Again the conclusion is that at both the 0.05 and 0.01 levels of significance, no significant difference exists in the distribution of gross income for the years 1968 and 1969; the null hypothesis is therefore accepted.

As the range of the last class interval narrows, the z statistic becomes a little larger. To assume that of the firms sampled in the over $2,500,000 category, none had income in excess of $3,500,000 would be unrealistic. This belief is not really important, since even if the last class interval exceeded $2,500,000 by only a dollar, the z statistic would not be more than the required 1.96, to alter the results at the 0.05 level of significance.

3. To ascertain whether gross income, and income from mutual fund sales are independent, another application of the Chi-Square Distribution, the Test of Independence using contingency tables was utilized. The null hypothesis is that income from mutual fund sales and gross income are independent. The results were:

<u>1968</u>

The x^2 value is 125.29

Present are $(r-1)(s-1) = (10-1)(6-1) = 45$ degrees of freedom

For a 5 per cent level of significance,

$P\ (61.7 < x^2 < \infty\ ) = 0.05$

The rejection region is $x^2 \geq 61.07$

Since x^2 is equal to 125.29, the hypothesis that income from mutual fund sales and gross income are independent is rejected.

1969

The x^2 value is 117.70

Present are $(r-1)(s-1) = (10-1)(6-1) = 45$ degrees of freedom

For a 5 per cent level of significance,

$P(61.7 < x^2 < \infty) = 0.05$

The rejection region is $x^2 \geq 61.07$

Since x^2 is equal to 117.70, the hypothesis that income from mutual fund sales and gross income are independent is rejected.

Analysis of the Collected Data

Table 18 shows the distribution of income from mutual fund operations as a per cent of gross income for all the questionnaires received, and also for the first and second responses. An increase in 1969 was found in the lower class limits, while in the upper class limits the number of firms decreased. While there was some change in the distribution between 1968 and 1969, as the statistical tests showed, differences in the distribution were not significant.

Table 19 gives the distribution of firms by gross income. All the firms sampled are shown in the first groups, and the next two show the distribution for the individual responses. In all the categories up to $1,500,000 there are some changes, but none of these appear to be significant except in the $100,000 -

TABLE 18

DISTRIBUTION OF QUESTIONNAIRES BY INCOME FROM MUTUAL FUND OPERATIONS AS A PER CENT OF GROSS INCOME

	All Questionnaires		Numbers 1-222		Numbers 223-286	
Mutual Fund Income as a % of Gross Income	Number of Firms		Number of Firms		Number of Firms	
	1968	1969	1968	1969	1968	1969
0 - 10	43	48	31	35	12	13
10 - 30	30	35	23	27	7	8
30 - 50	20	21	15	15	5	6
50 - 70	20	27	15	22	5	5
70 - 90	50	40	36	30	14	10
90 - 100	123	115	102	93	21	22
Total	286	286	222	222	64	64

Source: Questionnaires received from mutual fund retailers.

Notes:

Questionnaires 1 - 222 were received from the first mailing request.

Questionnaires 223 - 286 were received from the second mailing request.

TABLE 19

DISTRIBUTION OF QUESTIONNAIRES BY GROSS INCOME

	All Questionnaires		Numbers 1-222		Numbers 223-286	
	Number of Firms		Number of Firms		Number of Firms	
Gross Income	1968	1969	1968	1969	1968	1969
Under $50,000	127	131	100	105	27	26
$50,000 - $100,000	50	53	38	40	12	13
$100,000 - $200,000	38	30	31	23	7	7
$200,000 - $300,000	11	15	9	12	2	3
$300,000 - $500,000	14	11	8	7	6	4
$500,000 - $1,000,000	16	20	15	17	1	3
$1,000,000 - $1,500,000	10	7	8	7	2	0
$1,500,000 - $2,000,000	3	2	2	1	1	1
$2,000,000 - $2,500,000	1	2	1	1	0	1
Over $2,500,000	16	15	10	9	6	6
Total	286	286	222	222	64	64

Source: Questionnaires received from mutual fund retailers.

Notes:

Questionnaires 1 - 222 were received from the first mailing request.

Questionnaires 223 - 286 were received from the second mailing request.

$200,000 category where there was a decline from 38 to 30 in 1969.

Table 20 is constructed to show contingency tables for 1968 and 1969 by the two variables: (1) income from mutual fund operations as a per cent of gross income, and (2) gross income. These tables were necessary for the utilization of the Chi-Square Tests of Independence. Tables 21 and 22 show firms contemplating mergers. In Table 21, by far the greatest number is in the class limits 90 - 100 per cent; that is, the firms derive 90 - 100 per cent of their gross income from mutual fund sales. Table 22 shows that 37 of the 49 firms contemplating mergers have gross incomes of $100,000 or less. Forty-nine of the 53 firms contemplating mergers consider themselves to be principally retailers of mutual funds.

Table 23 gives a breakdown of the firms contemplating mergers, and an analysis of their gross incomes. For example, of the 49 firms considering a merger and which are principally mutual fund retailers, the gross incomes of 37 were unchanged in 1969. Of the 12 with changes in their gross incomes, income increased for three firms in 1969, and for nine firms income declined.

Tables 24 and 25 give a description of the firms which actually merged in 1969, broken down by the two income variables. Table 26 points out how much of an increase to gross income in 1969 the merger contributed. These tables bring out a significant

TABLE 20

QUESTIONNAIRES ARRAYED BY GROSS INCOME AND INCOME FROM MUTUAL FUND OPERATIONS AS A PER CENT OF GROSS INCOME

Gross Income	Mutual Fund Income as a Per Cent of Gross Income: 0 to 10	10 to 30	30 to 50	50 to 70	70 to 90	90 to 100	Total	Per Cent of Total
				1968				
Under $50,000	14	3	3	7	24	76	127	44.4
$50,000 - $100,000	2	7	13	4	7	17	50	17.5
$100,000 - $200,000	3	6	1	4	8	16	38	13.3
$200,000 - $300,000	3	3	1	1	2	1	11	3.8
$300,000 - $500,000	3	2	0	0	5	4	14	4.9
$500,000 - $1,000,000	5	3	0	2	2	4	16	5.6
$1,000,000 - $1,500,000	5	0	1	0	1	3	10	3.5
$1,500,000 - $2,000,000	0	1	0	1	1	0	3	1.0
$2,000,000 - $2,500,000	0	0	0	0	0	1	1	.4
Over $2,500,000	8	5	1	1	0	1	16	5.6
Total	43	30	20	20	50	123	286	100.0
				1969				
Under $50,000	19	5	7	8	17	75	131	45.8
$50,000 - $100,000	1	9	10	9	9	15	53	18.5
$100,000 - $200,000	4	7	1	4	1	13	30	10.5
$200,000 - $300,000	2	5	1	3	3	1	15	5.2
$300,000 - $500,000	2	1	0	1	3	4	11	3.9
$500,000 - $1,000,000	9	2	0	1	3	5	20	7.0
$1,000,000 - $1,500,000	2	2	0	0	1	2	7	2.4
$1,500,000 - $2,000,000	0	0	1	0	1	0	2	.7
$2,000,000 - $2,500,000	1	0	1	0	0	0	2	.7
Over $2,500,000	8	4	0	1	2	0	15	5.3
Total	48	35	21	27	40	115	286	100.0

Source: Questionnaires received from mutual fund retailers.

TABLE 21

FIRMS CONTEMPLATING MERGERS BECAUSE OF THE ELIMINATION OF GIVE-UPS AND OTHER REASONS

Mutual Fund Income as a Per cent of Gross Income 1969	Mutual Fund Retailers No. of Firms (1)	No. of Firms (2)	Total
0 - 10	1	0	1
10 - 30	1	2	3
30 - 50	2	1	3
50 - 70	6	1	7
70 - 90	8	0	8
90 - 100	31	0	31
Total	49	4	53

Source: Questionnaires received from mutual fund retailers.

Notes:

Firms whose principal business is retailing mutual funds and which are thinking of mergers numbered 49.

Firms contemplating mergers but which are not principally involved in the retailing of mutual funds amounted to 4.

1. Column (1) shows the number of firms whose principal business is retailing mutual funds.

2. Column (2) shows the number of firms whose principal business is not retailing mutual funds.

TABLE 22

FIRMS CONTEMPLATING MERGERS BECAUSE OF THE ELIMINATION OF GIVE-UPS AND OTHER REASONS

Gross Income 1969	Mutual Fund Retailers No. of Firms (1)	Mutual Fund Retailers No. of Firms (2)	Total
Under $50,000	23	1	24
$ 50,000 - $ 100,000	14	2	16
$ 100,000 - $ 200,000	4	0	4
$ 200,000 - $ 300,000	1	1	2
$ 300,000 - $ 500,000	3	0	3
$ 500,000 - $1,000,000	3	0	3
$1,000,000 - $1,500,000	0	0	0
$1,500,000 - $2,000,000	1	0	1
$2,000,000 - $2,500,000	0	0	0
Over $2,500,000	0	0	0
Total	49	4	53

Source: Questionnaires received from mutual fund retailers.

Notes:

Column (1) shows firms whose principal business is retailing mutual funds.

Column (2) shows firms whose principal business is not retailing mutual funds.

TABLE 23

FIRMS CONTEMPLATING MERGERS SHOWN BY PRINCIPAL TYPE OF BUSINESS AND BY CHANGE IN GROSS INCOME

	Gross Income in 1969 Unchanged From 1968	Gross Income in 1969 Changed From 1968	Total
Retailing Mutual Funds--Principal Business	37	12*	49
Retailing Mutual Funds--Not Principal Business	4	-	4
Total	41	12	53

Source: Questionnaires received from mutual fund retailers.

*Gross income of 3 firms increased in 1969:

From under \$50,000 to \$50,000-\$100,000	2	
From \$200,000-\$300,000 to \$300,000-\$500,000	1	3

*Gross income of 9 firms decreased in 1969:

From \$50,000-\$100,000 to under \$50,000	3	
From \$100,000-\$200,000 to \$50,000-\$100,000	2	
From \$100,000-\$200,000 to under \$50,000	1	
From \$300,000-\$500,000 to \$200,000-\$300,000	1	
From \$1,000,000-\$1,500,000 to \$500,000-\$1,000,000	2	9
		12

TABLE 24

FIRMS THAT MERGED IN 1969 BROKEN DOWN BY GROSS INCOME

Gross Income	Merged in 1969 Number of Firms
Under $50,000	1
$ 50,000 - $100,000	4
$100,000 - $200,000	4
$200,000 - $300,000	2
$300,000 - $500,000	1
Over $2,500,000	1
Total	13

Source: Questionnaires received from mutual fund retailers.

TABLE 25

FIRMS THAT MERGED IN 1969 BROKEN DOWN BY INCOME FROM MUTUAL FUND OPERATIONS AS A PER CENT OF GROSS INCOME

Mutual Fund Income as Per Cent of Gross Income	Merged in 1969 Number of Firms
0 - 10	1
10 - 30	2
30 - 50	0
50 - 70	2
70 - 90	2
90 - 100	6
Total	13

Source: Questionnaires received from mutual fund retailers.

TABLE 26

FIRMS THAT MERGED IN 1969 AND PER CENT INCREASE IN GROSS INCOME CAUSED BY MERGER

Gross Income	Percentage Increase in 1969 Gross Income Contributed by Merger (Number of Firms) 0-10	10-30	30-50	50-70	70-90	90-100	Total
Under $50,000	1	-	-	-	-	-	1
$ 50,000 - $100,000	4	-	-	-	-	-	4
$100,000 - $200,000	2	-	1	1	-	-	4
$200,000 - $300,000	2	-	-	-	-	-	2
$300,000 - $500,000	1	-	-	-	-	-	1
Over $2,500,000	1	-	-	-	-	-	1
Total	11	-	1	1	-	-	13

Source: Questionnaires received from mutual fund retailers.

point; despite the predictions that widespread mergers would result from the prohibition of customer-directed give-ups, few mergers actually occurred in 1969.

Tables 27, 28 and 29 indicate the amount of new reciprocal business received by firms to compensate for the loss of income brought about by the elimination of give-ups. As illustrated in Table 27, 44 firms specifically pointed out that they received no reciprocal business, although the questionnaire did not have a category for "zero" reciprocal business. The questionnaire had four categories, the first of which was 0 - 25 per

TABLE 27

NEW RECIPROCAL BUSINESS TO COMPENSATE FOR INCOME LOST THROUGH THE ELIMINATION OF GIVE-UPS

Per Cent of Lost Income Compensated by New Reciprocal Business	Number of Firms
0	44
0 - 25	214
25 - 50	10
50 - 75	12
75 - 100	6
Total	286

Source: Questionnaires received from mutual fund retailers.

cent. In this category are 214 firms, and perhaps many firms checking this category may have received no new reciprocal business since the firms did not specify actual percentages received. Tables 28 and 29 show new reciprocal business received by the two income variables. In Table 28 for example, in the "under $50,000" class, 26 firms received no new reciprocal business, while 102 firms received between 0 - 25 per cent. In Table 29 for example, for firms receiving 90 - 100 per cent of gross income from mutual fund sales, 19 received no new reciprocal business, while 92 received 0 - 25 per cent.

TABLE 28

NEW RECIPROCAL BUSINESS TO COMPENSATE FOR INCOME LOST THROUGH THE ELIMINATION OF GIVE-UPS (DISTRIBUTION BY GROSS INCOME)

Gross Income	Per Cent of New Reciprocal Business in 1969 (Number of Firms) 0	0-25	25-50	50-75	75-100	Total
Under $50,000	26	102	2	1	0	131
$ 50,000-$ 100,000	10	39	2	2	0	53
$ 100,000-$ 200,000	4	26	0	0	0	30
$ 200,000-$ 300,000	2	9	1	3	0	15
$ 300,000-$ 500,000	2	5	1	2	1	11
$ 500,000-$1,000,000	0	17	1	1	1	20
$1,000,000-$1,500,000	0	3	2	0	2	7
$1,500,000-$2,000,000	0	2	0	0	0	2
$2,000,000-$2,500,000	0	0	1	1	0	2
Over $2,500,000	0	11	0	2	2	15
Total	44	214	10	12	6	286

Source: Questionnaires received from mutual fund retailers.

Note:

The table above shows the distribution of new reciprocal business to compensate for the loss of income because of the elimination of give-ups.

TABLE 29

NEW RECIPROCAL BUSINESS TO COMPENSATE FOR INCOME LOST THROUGH THE ELIMINATION OF GIVE-UPS (DISTRIBUTION BY MUTUAL FUND INCOME AS A PER CENT OF GROSS INCOME)

Mutual Fund Income as a Per Cent of Gross Income	Per Cent of New Reciprocal Business in 1969 (Number of Firms)					
	0	0-25	25-50	50-75	75-100	Total
0 - 10	5	37	2	2	2	48
10 - 30	4	27	2	1	1	35
30 - 50	3	16	1	1	0	21
50 - 70	6	18	1	2	0	27
70 - 90	7	24	2	5	2	40
90 - 100	19	92	2	1	1	115
Total	44	214	10	12	6	286

Source: Questionnaires received from mutual fund retailers.

Table 30 shows the various types of comments made by the firms. A complete section has been devoted to these comments, so no further details will be given here.

Tables 31, 32 and 33 are devoted to the exchange membership of the firms surveyed. In 1968 only 57, or 20 per cent of the firms in the survey, belonged to a national or regional exchange; in 1969 the figures were 72, or 25 per cent. Tables 32 and 33 show the distribution of exchange membership by the two income variables. Very little change in membership was found to occur in individual exchanges except for the Philadelphia-Baltimore-Washington and Boston Stock Exchanges. For the Philadelphia-Baltimore-Washington, membership increased from 21 to 29 in 1969; and for the Boston, the increase was from 10 to 19 in 1969.

TABLE 30

COMMENTS ON HOW THE ELIMINATION OF GIVE-UPS HAS AFFECTED FIRMS

Type of Comment		Number of Firms
No comment made		76
The ban was detrimental, causing a decline in income		60
The ban had little or no effect on the firm's operations		45
Because of the ban changes were made in operating procedures:		
Income nevertheless declined	23	
No explanation of how the changes affected the firm	33	56
Despite the ban, no changes were made		47
The ban was justified		2
Total		286

Source: Questionnaires received from mutual fund retailers.

TABLE 31

EXCHANGE MEMBERSHIP OF FIRMS SURVEYED

	1968	1969
Member of an Exchange	57	72
Non-member of an Exchange	229	214
Total	286	286

Source: Questionnaires received from mutual fund retailers.

TABLE 32 - Page 1

DISTRIBUTION OF EXCHANGE MEMBERSHIP BY INCOME FROM MUTUAL FUND OPERATIONS AS A PER CENT OF GROSS INCOME

Mutual Fund Income as a Per Cent of Gross Income	Exchange Membership											
	None		NYSE		AMEX		Pacific Coast		Midwest		P-B-W	
	1968	1969	1968	1969	1968	1969	1968	1969	1968	1969	1968	1969
0 - 10	19	20	10	12	11	13	7	7	12	14	5	7
10 - 30	14	21	7	5	5	3	1	1	6	4	9	7
30 - 50	15	14	1	0	1	0	0	1	1	2	1	2
50 - 70	18	21	0	1	0	1	1	1	1	0	2	3
70 - 90	46	31	0	0	0	0	3	2	0	0	3	5
90 - 100	117	107	1	1	1	1	0	0	0	0	1	5
Total	229	214	19	19	18	18	12	12	20	20	21	29

TABLE 32 - Page 2

DISTRIBUTION OF EXCHANGE MEMBERSHIP BY INCOME FROM MUTUAL FUND OPERATIONS AS A PER CENT OF GROSS INCOME

Mutual Fund Income as a Per Cent of Gross Income	Exchange Membership											
	Boston		Detroit		Pittsburgh		Cincinnati		Other		Total	
	1968	1969	1968	1969	1968	1969	1968	1969	1968	1969	1968	1969
0 - 10	5	5	1	2	3	3	1	1	1	1	75	85
10 - 30	1	2	1	1	2	1	0	0	0	0	46	45
30 - 50	0	1	0	0	0	0	0	1	2	3	21	24
50 - 70	2	2	1	0	1	1	1	1	0	0	27	31
70 - 90	1	4	1	1	1	1	0	1	1	1	56	46
90 - 100	1	5	0	0	0	2	0	1	1	1	122	123
Total	10	19	4	4	7	8	2	5	5	6	347	354

Source: Questionnaires received from mutual fund retailers.

Note:

The totals do not equal 286 (number of firms surveyed) as several firms have memberships on more than one exchange.

TABLE 33 - Page 1

DISTRIBUTION OF EXCHANGE MEMBERSHIPS BY GROSS INCOME CATEGORIES

Gross Income	Exchange Membership											
	None		NYSE		AMEX		Pacific Coast		Midwest		P-B-W	
	1968	1969	1968	1969	1968	1969	1968	1969	1968	1969	1968	1969
Under $50,000	124	125	0	1	0	1	1	1	0	0	1	4
$ 50,000-$ 100,000	45	46	0	1	0	1	1	2	1	1	1	1
$ 100,000-$ 200,000	32	21	2	0	4	2	0	0	1	2	4	4
$ 200,000-$ 300,000	5	5	0	1	0	1	2	2	2	1	2	6
$ 300,000-$ 500,000	7	5	2	0	2	0	3	3	2	2	2	1
$ 500,000-$1,000,000	7	6	1	3	1	2	2	2	4	4	4	6
$1,000,000-$1,500,000	4	2	2	1	1	0	2	1	0	0	3	1
$1,500,000-$2,000,000	2	1	1	0	0	0	0	0	0	0	0	2
$2,000,000-$2,500,000	1	0	0	0	0	0	0	1	0	2	0	1
Over $2,500,000	2	3	11	12	10	11	1	0	10	8	4	3
Total	229	214	19	19	18	18	12	12	20	20	21	29

TABLE 33 - Page 2

DISTRIBUTION OF EXCHANGE MEMBERSHIPS BY GROSS INCOME CATEGORIES

	Exchange Membership											
	Boston		Detroit		Pittsburgh		Cincinnati		Other		Total	
Gross Income	1968	1969	1968	1969	1968	1969	1968	1969	1968	1969	1968	1969
Under $50,000	0	0	0	0	0	0	0	0	1	1	127	133
$ 50,000-$ 100,000	0	3	0	0	0	0	0	0	2	3	50	58
$ 100,000-$ 200,000	2	3	0	1	1	1	0	1	0	0	46	35
$ 200,000-$ 300,000	0	3	0	2	1	2	0	1	1	1	13	25
$ 300,000-$ 500,000	2	0	2	0	1	0	1	0	1	1	25	12
$ 500,000-$1,000,000	3	6	1	1	2	4	0	2	0	0	25	36
$1,000,000-$1,500,000	1	2	0	0	1	0	0	0	0	0	14	7
$1,500,000-$2,000,000	1	1	0	0	0	1	0	0	0	0	4	5
$2,000,000-$2,500,000	0	1	0	0	0	0	0	1	0	0	1	6
Over $2,500,000	1	0	1	0	1	0	1	0	0	0	42	37
Total	10	19	4	4	7	8	2	5	5	6	347	354

Source: Questionnaires received from mutual fund retailers.

Note:
The totals do not equal 286 (number of firms surveyed) as several firms have memberships on more than one exchange.

Conclusions on the Findings of the Survey

The results of the statistical tests indicated no significant change in the distribution of income from mutual fund operations between 1968 and 1969. The tests also indicated that changes in gross income of the firms surveyed were insignificant. Based on the sample results, must it be concluded that all mutual fund retailers were no worse off in 1969 than they were in 1968? This conclusion may not be warranted for two reasons: (1) there was not a one hundred per cent return on the questionnaires mailed; and as a result, the statistical purist would find such a conclusion improper; and (2) because of the size of the class limits of the two income variables, gross incomes of firms may have declined, yet not sufficiently for them to have moved to another class limit. For example, a firm in the $100,000 - $200,000 category may have grossed $180,000 in 1968 and $120,000 in 1969, but this change would not have been taken into account. Again, a firm may have received 85 per cent of its gross income from mutual fund sales in 1968, and only 71 per cent in 1969, but still it would have remained in the same class limit.

This limitation is but one to be found in the study; it was recognized by the author and members of his committee. However a large number of class limits was believed to detract from the compactness of the questionnaire, and seriously threaten the success of the responses.

Is the conclusion, then, that mutual fund retailers have been seriously hurt by the elimination of customer-directed give-ups? On the contrary, the comments made would seem to indicate that a great many firms were (1) either not affected because they never received give-ups, or had received insignificant amounts; and (2) had made changes to compensate for the income lost from the elimination of give-ups. Some of the more important changes were:

(a) A decrease in commissions to registered representatives selling fund shares.

(b) An increase in sales of life insurance, and over-the-counter securities.

(c) Introduction of block trading departments.

(d) Membership on the regional exchanges.

(e) Merging with other firms.

(f) A reduction in office and sales personnel.

(g) A decline in services to clients, and a marked decrease in extra services.

(h) Sales of mutual fund shares which paid higher dealer allowances.

Many respondents indicated that the ban had been detrimental and was directly responsible for a decline in net income. Somehow this claim seems exaggerated, especially since almost all of the firms surveyed were involved in security transactions, other than the sale of mutual fund shares. One may recall that

1969 was a poor year for the securities industry. Therefore, the total decline in the securities markets must be taken into account, and must have contributed to any loss of income suffered by the firms in the survey. Perhaps the following comment from one of the questionnaires, and a very honest one at that, best illustrates what has really occurred:

> It is not the loss of customer-directed give-ups which have caused this industry problems, rather the severe reduction of trading volume and the associated decrease in value in the securities traded. Firms geared up too late to meet the volume crisis in 1968-1969, and once again are too late in reducing fixed cost levels in proportion with the reduced volume. The pricing structure in this business is antiquated. It is currently related to number of shares and price rather than to cost. The proposals to restrictive commissions rates currently before the SEC is definitely a step in the right direction.

If the comments are to be taken at face value, then perhaps one unfortunate consequence of the ban may have been its effect on the investing public, since the two most recurrent comments were: (1) services rendered to the investing public have declined; and (2) mutual fund retailers are now pushing mutual fund shares which pay a higher dealers' allowance, and which may not be suited to the clients' needs. This aspect will be further discussed in the chapter dealing with the author's conclusions.

The author's conclusion is that the death tolls prophesied by the NASD and others for retailers of mutual funds were premature. These predictions were based on three premises: (1) that all firms received give-ups; (2) that no costs were allocated to the receipts of give-ups; and (3) that firms which lost income from the elimination of give-ups would quietly fade away, without initiating changes to compensate for lost income. An examination of the comments shows quite plainly that all firms certainly did not receive give-ups. As one firm stated,

> . . . the funds wanted a large volume from us before they would give much in the way of give-ups. If anything, the ban may have helped us by causing a trend toward higher direct commissions of which we automatically receive our share.

While the NASD and others may not have allocated costs to give-ups, the mutual fund retailers certainly did, and their reduction of services to clients bears out this fact. This was one of the most prevalent of the comments. Finally, the firms did not stay static, but made changes in their organization structures to offset any loss in income, and these changes were previously listed. Not all these changes were beneficial; apparently joining regional exchanges did not prove to be the panacea to mutual fund retailers, notwithstanding claims of the regional exchanges.

Selected Comments from the Questionnaires

Question 7 of the questionnaire asked, "Have you any comments on how the ban on give-ups has affected your firm? Has it caused changes such as the introduction of a block trading department, changes in the sales force, etc., in your company that would not normally have taken place?" Some of the more interesting and pertinent ones have been selected for inclusion.

The comments are quoted verbatim; no attempt has been made to correct grammatical errors or improve sentence structure, because to tamper with them would destroy their stark and honest realism. In addition, the comments have been grouped by type. For example, one group of comments relates to changes made by broker-dealer firms as a direct result of the ban; another group of comments are from firms which received few or no give-ups, or were not affected by the ban.

1. <u>Comments Relating to Changes in the Organization Structure</u>

Absolutely necessary to receive give-ups just to survive. We have changed Commission schedules, merged and introduced block trading.

Opening a New York City office. Installing equipment and arranging organization for block trading.

More consideration to having customers purchase stock and no load funds.

It forced me on to PBW--only to find out holding seat to get Mutual Fund Portfolio Trades to replace give-ups didn't pay. Sold seat--merged with firm that has seat.

Required setting up block trading department and hiring floor broker on exchange.

Net profit sharply reduced and have had to cut many "extra" customer services or charge for what used to be free.

It has caused us to place less emphasis on mutual fund sales and more on individual stock and bond sales.

When I can, I now sell funds with the highest dealer allowance. This may not always be in the best interest of client. However it does help to make up some for loss of give-ups. The loss of give-ups together with poor business has greatly reduced our income. As a small business we are working hard to swim.

Forced us to go into over-the-counter stock business. Now business is such that we have neither mutual fund or OTC business.

Reduced funds for promotion, office help, etc., considering moving to a member firm to allow for reciprocal.

I have had to reduce commission percentage to reg. reps. and as a result have lost 1/3 my sales force. This 1/3 being the best producers.

More concentration on Life and H & A Insurance sales.

We have reduced compensation paid R. R. from 60% to 50% on mutual fund orders.

Reduced commissions to salesman; cut profit on gross sales 60% almost put us out of securities business; sell insurance and bank certificates of deposits now too.

This will, in our opinion, have serious effects on the investing public that apparently the SEC does not forsee.

Its immediate personal affect on us is to reduce our net income to the point where we may be forced to merge (unwanted) or go out of business. Our sales force was reduced and our commission schedule lowered--we can't spend the time supervising and training to the extent we would like to.

We were "victimized" in 1969 by computers and operational problems of our two fund distributors (both long established and quality organizations) which caused us to spend the first four months of 1969 doing virtually nothing but trying to get records straight.

This caused thousands of dollars loss to us and there was no way such through a give-up to pay us for something that we were not at fault in any way. We try to keep our expenses down and have considered any give-up revenue (which we have had small amounts of) as a plus. However, expenses are going up so fast the small dealer can't survive under a competitive <u>dis</u>advantage against stock exchange firms.

The problem for the dealer is <u>not</u> separable to give-ups alone, he must consider all phases of industry changes such as brokerage commissions, access to the NYSE, declining income from rights of accumulation, quality of customer service and the tremendous impact of the compliance requirements of the SEC, NASD and state securities commissions. It's getting impossible to function properly to the detriment of the customer/client.

It has made the sale of mutual funds non-remunerative after commissions paid to salesmen. This firm has organized an over-the-counter trading department to try to compensate.

Caused our firm to get a Boston Exchange seat which has been useless in 1970 due to mutual funds being frightened by stockholders' suits and SEC pressures. The SEC has bolstered the NYSE as the dealer to mutual funds has no access and very little or no give-up business. It has forced us to concentrate more on life insurance sales.

The old give-up system was great--we've lost money by having to buy and operate a PBW seat. We're lucky we're not out of business.

Has reduced incentive to recruit and train new sales personnel.

More effort toward a strong institutional sales department.

(1) Reduction--in commissions to salesmen.
(2) Reduction of back office help.
(3) Lowering of service level to clients.
(4) Diversification of efforts from M. F. sales.
(5) Merger.

Caused us to join Boston Stock Exchange ($14,000); put on full time trader $1,000 per month; install Bunker-Ramo quote machine 330.00/month. All this encourages retail sales of individual stocks, however, so there is partial offset to expense.

(1) Formed Institution (block trading) dept.
(2) Changed structure of company to pay less commissions.
(3) Developed new product lines.
(4) Cut back overhead where possible.

Formed affiliate and joined PBW. Results: have not received one order from mutual funds.

2. Firms Receiving Few Give-ups--Firms Not Affected by the Ban

Small firm - sole propriator - only had 1 give-up.

We were not seriously hurt in 1968-69 by discontinuance of give-ups. Our mutual fund business has been going down since 1966.

Our firm derived 40-65% of its net operating profit from reciprocal mutual fund brokerage. In 1968, we made $30,000. In 1969 we lost $6,000. We have had a loss every month of 1970. Mutual fund recip. is vital--cust. give-ups are of no importance to us.

As a small firm we never relied on give-ups from funds although we did receive them from time to time.

Our receipt of give-ups was not material in the first place so the ban on give-ups has not been materially effective in reducing our income.

We are a small office and we never did receive anything of any consequence even before.

We never received give-ups, therefore the ban has not affected us as much. However, we were close to being put on a list to receive give-ups when the ban went into effect. Needless to say we are unhappy about it.

Very little. Sold funds that paid direct commission instead of using give-ups.

Our firm is too small to be affected in any way. Our growth will continue regardless of ban on give-ups.

This firm never has received give-ups, therefore question 6 is not applicable.

Being a small broker dealer the give-ups while nice to get, make no difference in the years picture of financial earnings.

No effect due to ban as I never asked for a give-up.

No real change -- Fund volume didn't justify many give-ups.

None -- we had none to begin with.

This operation is too small to be affected.

It is not the loss of customer directed give-ups which have caused this industry problem, rather the severe reduction of trading volume and the associated decrease in value in the securities traded. Firms geared up too late to meet the volume crisis in 1968-69 and once again are too late in reducing this fixed cost levels in proportion with the reduced volume. The pricing structure in this business is antiquated. It is currently related to number shares and price rather than to COST. The proposals to restrictive commissions rates currently before the SEC is definitely a step in the right direction.

We had had only one give-up transaction, back in 1962 or 1963 where we received less than $100, if memory serves correctly.

3. Firms which Considered the Ban Detrimental

The ban on give-ups will soon result in our going out of business or forcing us to merge. We have been in business for 36 years specializing in Mutual Funds and Term Life Insurance. As time passes the amount of time required to service clients when there is no new business or profit involved increases substantially and the give-ups partly compensate for the time and expense of their service. This expense is not recognized by the SEC but it is real for any dealer who lives up to his responsibilities; without compensation for the cost of this service you can't stay in business and the investor is the one who will suffer in the end.

It has all but forced us to close down business. I'm afraid that it is certain that we will have to. If legislation is not forthcoming within a few months. The major Broker-Dealer firms in bed with the SEC have precipitated this calamatous situation, inimical to the American free enterprise system.

It has had a direct affect of the profitability of the firm. Firms such as this one have built the mutual fund industry and give-ups were a vital means of compensation for this effort.

It is true that practically all mutual fund portfolio trading is handled by the larger firms with exchange connections. The small dealer had been squeezed out of this business. Of course, to us the small dealer, this does not seem fair. Only those who have tried to market mutual funds know how small the commissions are for the effort involved. So the reciprocal became an important part of our gross with which to help cover the overhead in maintaining a brokerage office for service to the public.

Most business is based somewhat on reciprocal arrangements and practically all political government is, too. Whatever savings, if any, has been made for the public by the new ban on reciprocal, has been lost by the huge expenditure of time and money the government took to investigate it.

We, as a small dealer, are still considering whether or not to continue the business.

In 1968 I received 2400 dollars in give-ups. In 1969, none. My personal income was 11,600 in 1968 and $9,400 in 1969. Despite the decline in the market in 1969 I did almost as much business -- thus the decline in my personal income was almost directly proportional to the end of give-ups.

With exactly the same production of Mutual Fund business, our commission income was reduced by exactly 12,000 dollars - accountable only because of ban on give-ups.

We were selling cash and open accounts (no contractuals); the ban effectively eliminated our net profits and we merged with a larger N.Y. City firm. Increase in record keeping and over-regulation of small brokers is an even bitter item. The N.Y.S.E. deserves all that is coming to them for trying to "hog" all the business.

The ban on give-ups has ruined us along with low volume, if the intent of SEC ban on give-ups is to put small broker dealers bankrupt they have suceeded only far too well - larger firms too are in chaotic condition. The only alternative is to nationalize as will happen to Penn Central. The Ban begins the death throes of our free enterprise system.

4. Firms which Considered the Ban Justified

The ban on give-ups restricts the profitability of mutual fund oriented firms by 25% to 50%; however, where savings in commissions rebound to fund shareholders, I believe the ban is justified.

Being a small firm, we received very little in the way of give-ups. The funds wanted a large volume from us before they would give much in the way of give-ups. If anything, the ban may have helped us by causing a trend toward higher direct commissions of which we automatically receive our share. We always resented the fact that large houses specializing in trading often received more on fund sales than we did, so we are not unhappy with the loss of give-ups.

5. Miscellaneous Comments

Changes on give-ups made us think and act. We took membership on an exchange, bought another company and both of these were very helpful to us. (and started block trading). However, we were fortunate to have some money and also know-how in regards to security business. Others were not as fortunate. Therefore we have increased our business as a result of the changes and I think we will continue to do so in the future.

Without trying to sound like a "do-gooder", our sales organization was structured to do the best for our clients. Our commission structure to our sales people was, and is the same, regardless of which fund they sell. Thus we felt the sales people would not be swayed in recommending a fund to their clients whether sales commission to us was 6% or 8%; we paid our people the same commission on all funds. There were funds that came to see me offering "give-ups" that were directed to us. However at the peak it never reached more than $10,000 since the majority of funds we sold had a "no give-up" policy. I also used "give-ups" to purchase dealer service by directing this business to a house that offered these services. Therefore the ban on "give-ups" didn't necessitate any changes on our part - although with business the way it is this year that extra income could have come in handy as I would imagine it has with many other organizations.

The problem as I see it was that "give-ups" did no harm as originally instigated but, like every good thing it was abused out of proportion. The funds instead of spreading out this money to all in proportion to the business, were giving "member firms" 4% to 6% while allocating little if nothing to planning companies such as ours. Their argument was that it was easier to direct the business to "member firms" when the real reason in my mind was that they were looking for the big ticket sales. My feeling was that they were wrong from an ethical point as well as from a business point (which is the bigger error in judgement).

My personal feelings are that "give-ups" if allocated properly are a good thing - but they were abused. I had a "no load" fund offer me 8% reciprocal to sell their fund - can you imagine the churning necessary to generate that commission. Still I cannot see the difference of selling a fund for give-ups or an organization having a "house fund" and pushing this fund with higher commissions to the sales people. It boils down to the same thing - not selling the best but selling where you get the most.

I hadn't intended to go into such a lengthy note but above are my feelings. I hope this gives you some insight of the problem and if I can be of any further assistance please do not hesitate contacting me.

My gross income last month was 106 dollars. Did the SEC people who wrote the report accept an increase in salary recently? I've done statistical analysis all my life. The SEC report was either the most incompetent or completely dishonest statistical work I have ever seen. You may quote me.

It is not the loss of customer directed give-ups which have caused this industry problems, rather the severe reduction of trading volume and the associated decrease in value in the securities traded. Firms geared up too late to meet the volume crisis in 1968-69 and once again are too late in reducing thin fixed cost levels in proportion with the reduced volume. The pricing structure in this business is antiquated. It is currently related to # shares and price, rather than to COST. The proposals to restrictive commissions rates currently before the SEC is definitely a step in the right direction.

There was no real consensus in the comments of the respondents. While many stated that the ban on customer-directed give-ups had been detrimental to their firms, a large group either were not directly affected, or made adjustments to offset any harmful effects of the ban. The fact that there was no consensus as to the detrimental effects of the abolition of give-ups is significant, since the lack of consensus supports the author's contention that too much emphasis had been placed by the securities industry on the negative or harmful effects of the abolition and not enough on the beneficial aspects. The comments also indicated that a great many broker-dealers never received give-ups, and that a decline in income for individual firms was caused by factors other than the abolition.

PART III

THE IMPACT OF THE ABOLITION OF CUSTOMER-DIRECTED GIVE-UPS ON REGIONAL EXCHANGES

CHAPTER VI

THE REACTION OF THE REGIONAL EXCHANGES TO THE PROPOSALS OF THE NYSE AND THE SEC

When the SEC invited comments on its proposed Rule 10b-10 and the NYSE commission rate structure proposals, among those eagerly accepting the invitation were the Midwest, Pacific Coast, P-B-W, Boston and Detroit stock exchanges. These five exchanges accounted for approximately 90 per cent of the volume on all regional exchanges during the period 1960-1969. During the same period, volume on the Midwest and Pacific Coast exchanges was approximately 70 per cent of total volume on all regional exchanges. In view of what later occurred, a brief review of the comments of the major regional exchanges should prove rewarding.

Midwest Stock Exchange

With regard to the proposed volume discount of the NYSE, the President of the Midwest Stock Exchange stated that a volume discount on large transactions without attention paid to the economic consequences for the securities industry would probably be disastrous.

> If the consequences of a volume discount would eliminate, through pressure for merger or other reasons, regional brokerage firms serving legitimate objectives, then we feel the investing public would be the ultimate loser. Because, in addition to high-grade distribution facilities which could

> be maintained by the merged entity, the regional firms represent a diversity of judgement and, therefore, an element of competition that benefits the securities industry and the public it serves.[1]

One of the initial proposals of the NYSE was to support continuation of customer-directed give-ups, but to limit the amount which could be given up. The Midwest Stock Exchange had no objections to this proposal, as long as the limitations proposed by the NYSE did not give one exchange an advantage over the other exchanges.

As explained in Part I, Rule 10b-10 was meant to prohibit investment companies from directing brokers executing orders for the companies to split commissions with other brokers or dealers unless the benefits of the division accrued to the investment companies. The Midwest Stock Exchange strongly opposed adoption of the rule because it believed this adoption would lead to institutions fragmenting their orders among various brokers. Although this method would provide some commission business to brokers for services rendered to the investment companies, the end result would be less efficient execution of orders. In addition, the Midwest Stock Exchange felt that Rule 10b-10 did not deal with the real problems, but instead created new or magnified existing problems. According to the President of the Midwest Exchange, the Rule paid no attention to the economic consequences

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[1] Selected Comments on SEC Proposed Rule on Give-ups and NYSE Proposal on Commission Rates (Chicago: Commerce Clearing House, Inc., 1968), p. 50.

of its adoption since it would "obviously create pressure for mergers of brokerage firms, a reduction of competition at the firm level, a concentration of business in one market, and a reduction of effective competition with that market by other exchanges."[2]

Pacific Coast Stock Exchange

The Pacific Coast Stock Exchange considered the NYSE proposals nothing more than an effort to receive the assistance of the SEC in increasing the NYSE's share of trading in NYSE listed securities from 90 per cent to close to 100 per cent. This would be accomplished by an almost total elimination of trading on regional exchanges of NYSE listed securities. The Pacific Coast Exchange, in the words of its President, strongly opposed the NYSE proposal

> . . . since it would not be in the public interest and no justification for it has been advanced. It would not solve the problems raised by the Commission (SEC), and it would have a devastating impact on the regional exchanges. Its purpose is plainly anticompetitive. It would result in a virtual monopoly of exchange business at a time when facilities in New York are inadequate to handle present and potential volume.[3]

Among the other comments made by the Pacific Coast Exchange relative to the NYSE proposals were:

1. The NYSE did not want to abolish all types of reciprocal business practices resulting in commission leakage, but only

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[2] *Ibid.*, p. 53.

[3] *Ibid.*, p. 68.

those arrangements which aided its competitors; in other words, the NYSE wanted to prohibit only those reciprocal arrangements which utilized the facilities of competing regional stock exchanges.

2. An estimated 35 per cent to 45 per cent of all Pacific Coast Stock Exchange volume was supposed to be a direct result of reciprocal practices; this volume would be lost if reciprocal arrangements were prohibited.

3. The Pacific Coast Exchange believed that each regional exchange should be responsible for determining the percentage of commissions to be given up. It considered a uniform limitation on give-ups which would be applicable to all exchanges unnecessary and extremely dangerous.

The Pacific Coast Stock Exchange was less hostile to the SEC-proposed Rule 10b-10. Nevertheless, the Exchanged pointed out that adoption of the rule would have a marked impact on existing practices relating to give-ups and reciprocals, and would inevitably cause a large reduction in the volume of transactions on the Pacific Coast Exchange. The Exchange estimated that if Rule 10b-10 had been in effect during 1967 volume would have declined by approximately 25 to 35 per cent. The President of the Pacific Coast Exchange concluded by stating that

> . . . it seems clear that, after adoption of the proposed rule, very small firms now receiving give-ups as compensation for sales of investment company shares would not be able to receive that compensation by executing portfolio orders, that some larger firms would get more portfolio orders, and that

> the combination of forces that determine the market in which an order is executed would be changed dramatically with a resulting change in those markets.[4]

Philadelphia-Baltimore-Washington Stock Exchange

The President of the P-B-W Stock Exchange termed the NYSE proposals,

> . . . the product of hasty drafting, designed to meet the threat of SEC regulatory action in the form of Rule 10b-10. Though they deal with rather specific aspects of the commission structure, they are designed to implement a series of complex value judgements on the relative roles of the NYSE and the regional stock exchanges (assuming there is to be any role left for the regional stock exchanges).[5]

The P-B-W Stock Exchange further stated that the NYSE proposals were primarily directed at the regional stock exchanges because of the competition with which they threatened the NYSE.

The P-B-W Stock Exchange also found fault with the SEC proposed Rule 10b-10 since it seemed to be based on the assumption that the person receiving the give-up either incurred no cost, or rendered no service in connection with the order from which the give-up was derived. The P-B-W flatly rejected these assumptions as being unsound.

Boston Stock Exchange

The Boston Stock Exchange rejected the NYSE proposals on the ground that (1) they were not justified by existing conditions

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[4] *Ibid.*, p. 64.

[5] *Ibid.*, p. 70.

in the securities industry and would have serious adverse consequences on competing markets; (2) the aim of the proposals was to reduce healthy competition from other markets; and (3) adoption of the proposals would have disastrous effects on the growth potential of the regional exchanges and would threaten their very existence.

In connection with the SEC's Rule 10b-10, the Boston Stock Exchange considered it impractical and inequitable. The Exchange believed that a volume discount resulting from an adjustment in the minimum commission schedule would be more realistic and practical.

Detroit Stock Exchange

Like the presidents of the other regional exchanges, the Detroit Stock Exchange President was not sympathetic toward either the NYSE or the SEC proposals. The Exchange felt that the proposals, if adopted, would have effects completely disproportionate to the supposed benefits that could accrue. These effects would include:

> (1) a likely destruction of the ability of virtually all of the regional stock exchanges to operate as viable mechanisms in the securities markets; (2) an unhealthy and monopolistic concentration of stock exchange business in a single exchange in one financial center of the nation; (3) a shift in revenues within the securities industry which would aggrandize the major stock exchange firms in New York but would severely prejudice and perhaps render insolvent the smaller and medium size firms which generally are located in other parts of the country and who often perform functions for local investors and enterprises that the majors do not provide; and (4) an

acceleration of the unhealthy trend toward merger into the larger securities firms.[6]

The consensus of all the presidents of the regional exchanges was that the NYSE proposals were aimed at reducing competition on the regional exchanges. These men believed that reduced competition would eventually lead to the destruction of the regional exchanges. Based on the increased share volume of the major regional exchanges in 1969, this pessimism appeared to have been premature and unfounded.

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[6] *Ibid.*, p. 74.

CHAPTER VII

THE GROWTH OF THE REGIONAL EXCHANGES

Share and Dollar Volume of the Regional Exchange

In Chapter VI, the reactions of the major regional exchanges to the prohibition of customer-directed give-ups and the institution of the volume discount were reviewed. The universal complaint was that adoption of these measures would adversely affect the regional exchanges because of the substantial reduction in volume of trading that would occur.

A review of Table 34 shows that the Pacific Coast, Midwest and P-B-W Stock Exchanges increased their volume of trading in 1969, while the Boston and Detroit Stock Exchanges suffered a decline. In addition, both major stock exchanges, the NYSE and AMEX also showed declining volume. Volume on the Pittsburgh and Cincinnati Stock Exchanges represents a minute portion of total volume.

Table 35 shows the percentage increase or decrease in volume of trading in 1969 for the major registered exchanges. The P-B-W showed the most significant increase, although to be noted here is that part of the increase in 1969, and also of previous years, can be attributed to orders originating from the Pittsburgh Stock Exchange, but executed on the floor of the

TABLE 34

STOCK VOLUME ON THE MAJOR REGISTERED STOCK EXCHANGES, 1960-1969

	Number of Shares (Millions)								
Year	NYSE	AMEX	Pacific Coast	Midwest	P-B-W	Boston	Detroit	Pittsburgh	Cincinnati
1960	766.7	286.0	44.9	31.0	.[a]	5.6	4.8	0.8	0.7
1961	1,021.3	488.8	73.2	43.0	15.6	6.3	6.5	1.0	0.9
1962	962.2	308.7	50.6	40.0	14.8	5.3	6.2	1.7[b]	0.8
1963	1,146.3	316.7	53.1	43.0	15.8	5.6	8.8	1.9[b]	0.8
1964	1,236.6	374.2	56.2	50.0	18.6	5.9	11.5	1.1	0.8
1965	1,556.3	534.2	62.4	69.0	20.8	7.1	14.2	1.1	1.3
1966	1,899.5	690.8	88.9	84.0	28.6	13.3	15.1	1.2	1.8
1967	2,530.0	1,145.1	114.3	109.0	38.5	20.1	15.3	1.2	1.1
1968	2,931.6	1,435.8	143.3	141.0	48.1	42.4	17.1	1.3	0.6
1969	2,850.8	1,240.7	171.9	146.0	62.5	23.4	6.4	1.4	0.3

Sources: NYSE Fact Book, 1970, p. 72.
Letter from John C. Ford, American Stock Exchange, March 18, 1970.
Letters, questionnaires and annual reports from the Regional Exchanges.

[a]The P-B-W was unable to supply this information.

[b]These figures include shares executed on the P-B-W and Boston exchanges. Prior to its merger with the P-B-W at the end of 1969, the Pittsburgh exchange had an association with the P-B-W and Boston exchanges. No breakdown on the figures for 1962 and 1963 were available.

TABLE 35

PERCENTAGE INCREASE (DECREASE) IN 1969 SHARE VOLUME
FOR THE MAJOR REGISTERED STOCK EXCHANGES

Exchange	Share Volume (Millions) 1968	Share Volume (Millions) 1969	Percentage Increase (Decrease)
NYSE	2,931.6	2,850.6	(2.8)
AMEX	1,435.8	1,240.7	(13.6)
Pacific Coast	143.3	171.9	20.0
Midwest	141.1	146.0	3.5
P-B-W	48.1	62.5	29.7
Boston	42.4	23.4	(44.8)
Detroit	17.1	6.4	(62.6)

Source: Calculations made from data shown in Table 34.

P-B-W. The Pacific Coast also increased its share volume by approximately 20 per cent, and the Midwest by a more modest 3.5 per cent. A significant decline occurred in share volume on both the Boston and Detroit Exchanges. The decline on the Detroit Stock Exchange was so severe, that one would have to go as far back as 1962 to find a lower annual volume.

Table 36 shows the dollar volume on the major registered exchanges for the ten year period ending 1969. The movement in dollar volume parallels that of share volume; for example, as share volume increased, the corresponding dollar volume also

TABLE 36

DOLLAR VOLUME ON THE MAJOR REGISTERED STOCK EXCHANGES 1960-1969

Year	Market Value of Shares (Millions of Dollars)								
	NYSE	AMEX	Pacific Coast	Midwest	P-B-W	Boston	Detroit	Pittsburgh	Cincinnati
1960	37,960.0	4,235.7	883.4	1,235.0	.[a]	272.2	154.5	28.3	34.9
1961	52,699.0	6,863.1	1,279.8	1,761.0	663.3	318.5	240.6	35.4	46.6
1962	47,341.0	3,736.6	1,097.2	1,512.0	577.1	252.4	230.0	66.1[b]	38.5
1963	54,887.0	4,844.9	1,542.4	1,756.0	688.4	274.1	334.9	77.8[b]	40.9
1964	60,424.0	6,127.2	1,800.0	2,286.0	827.9	310.1	481.3	45.3	46.4
1965	73,200.0	8,874.9	2,179.9	3,086.0	1,009.0	382.4	630.5	45.3[c]	72.5
1966	98,565.0	14,647.2	3,524.0	3,887.0	1,365.3	700.6	706.1	49.2	97.7
1967	125,329.0	23,491.3	4,538.6	4,996.0	1,832.9	1,091.6	709.6	49.2[c]	62.3
1968	144,978.0	34,775.4	5,242.0	6,151.0	2,115.8	2,055.2	696.6	53.3[c]	34.1
1969	129,603.0	31,036.9	5,513.7	6,000.0	2,750.0[c]	1,191.3	216.6	46.6	19.1

Sources: *NYSE Fact Book*, 1970, p. 75.
AMEX Databook, 1969, p. 36.
American Stock Exchange Annual Report, 1969, p. 1.
Letters, questionnaires and annual reports from the Regional Exchanges.

[a]The P-B-W was unable to supply this information.

[b]These figures include shares executed on the P-B-W and Boston exchanges through an association agreement.

[c]The exchanges were unable to supply the information. The figures are therefore estimates based on average share price for the preceding years.

increased and vice versa. One exception occurred in 1969, and this exception was the Midwest Stock Exchange; dollar volume of shares traded declined, despite an increase in the number of shares traded.

Table 37 compares the percentage of shares traded on the NYSE with the AMEX and all other registered exchanges.

TABLE 37

PERCENTAGE COMPARISON OF SHARES SOLD ON REGISTERED EXCHANGES, 1960-1969

	Per Cent of Total		
Year	NYSE	AMEX	Other
1960	69.1	21.6	9.3
1961	64.3	26.1	9.6
1962	71.3	20.0	8.7
1963	73.5	18.3	8.2
1964	72.5	19.4	8.1
1965	70.0	22.5	7.5
1966	69.2	22.9	7.9
1967	64.1	28.6	7.3
1968	62.1	29.6	8.3
1969	64.0	27.0	9.0

Source: Securities and Exchange Commission, quoted in New York Stock Exchange Fact Book (1970), p. 75.

Table 38 gives similar information, but market value of shares traded is substituted for share volume. After five successive years of decline, the NYSE percentage of all exchange share volume increased to approximately 64 per cent in 1969. The AMEX, in contrast, after five successive years of increasing proportions, declined to approximately 27 per cent in 1969 from

TABLE 38

PERCENTAGE COMPARISON OF MARKET VALUE OF SHARES SOLD ON REGISTERED EXCHANGES, 1960-1969

	Per Cent of Total		
Year	NYSE	AMEX	Other
1960	84.0	9.2	6.8
1961	82.6	10.6	6.8
1962	86.5	6.7	6.8
1963	85.3	7.4	7.3
1964	83.8	8.2	8.0
1965	82.0	9.7	8.3
1966	80.1	11.5	8.4
1967	77.5	14.3	8.2
1968	73.8	17.7	8.5
1969	73.9	17.2	8.9

Source: Securities and Exchange Commission, quoted in New York Stock Exchange Fact Book (1970), p. 75.

an all time high of 29.6 per cent in 1968. The regional exchanges improved their proportion in 1969, with nine per cent of all shares traded, almost one full per cent from the prior year. This showing was the best for the regional exchanges since 1961. The story was similar for dollar volume, although a review of Table 38 shows that with the exception of 1967, the regional exchanges have been increasing their proportion annually. In 1969, the regional exchanges accounted for 8.9 per cent of dollar volume, which was a record high. This increase reflects a concentration of trading on these exchanges in higher priced, dually listed stocks.

Block Transactions on the Major Registered Exchanges

On all the major registered exchanges with the exception of the Detroit Stock Exchange, block volume as a per cent of total volume of trading increased in 1969. This occurred despite the decline of approximately 6.6 per cent in the volume of shares traded on all registered exchanges, and the decrease in volume on most of the individual exchanges.

Table 39 shows block trading activity on the major registered exchanges for the period 1965-1969. Information for certain years was unobtainable as the exchanges did not have statistics available. Although the Detroit and Cincinnati Stock Exchanges did not have records on block transactions, they provided estimates. In the case of the Detroit Exchange, the

TABLE 39

BLOCK TRADING STATISTICS ON THE MAJOR REGISTERED EXCHANGES, 1965-1969

	Per Cent of Total Volume								
	NYSE (a)	AMEX (b)	Pacific Coast (b)	Midwest (c)	P-B-W (c)	Boston (d)	Detroit (b)	Pittsburgh (e)	Cincinnati (b)
1965	3.1	.f	20.0	.f	.f	.f	70.0	-	15.0
1966	4.5	1.0	33.0	.f	.f	.f	75.0	-	50.0
1967	6.7	1.6	33.0	.f	.f	42.3	70.0	-	24.0
1968	10.0	2.5	32.0	27.6	37.5	52.6	65.0	-	4.0
1969	14.1	4.9	36.0	32.9	50.8	55.8	5.0	-	1.5

Sources: (a) NYSE Fact Book, 1970.
(b) Obtained directly from the exchange.
(c) "The Changing Face of Reciprocity," Securities Magazine (June 1970), p. 26.
(d) Calculated from raw data supplied by the exchange.
(e) There was only one block transaction on the Pittsburgh Stock Exchange during the period 1960-1969; this occurred in 1965.
(f) Exchange did not have information available.

Note:

On the NYSE and AMEX a block is a unit of 10,000 or more shares. On the Midwest, P-B-W and Boston, the unit is 2,000 shares or more, and on the Pacific Coast, 1,000 shares or more.

estimates for the period 1965-1968 seem unusually high, while the 1969 figure seems completely out of line with the other exchanges, notwithstanding the extremely sharp decline in volume of trading. The estimates for the Cincinnati Exchange are not really material because of the low volume of shares transacted on this exchange.

The increased block activity obviously represents increased institutional participation in the stock market. Table 40 shows purchases and sales of common stock by major financial institutions for the period 1960-1969. Despite the decline in total stock volume in 1969, aggregate purchases and sales by the major financial institutions reached a record level. Since 1960, institutional purchases and sales have increased over seven times. In 1969, each of the major financial institutions were more active than in any previous years. Undoubtedly, part of the increased institutional activity was reflected in the increased volume on some of the regional exchanges. In Chapter VIII the reasons for the inequitable distribution of volume of trading on the regional exchanges during 1969 will be discussed.

TABLE 40

PURCHASES AND SALES OF COMMON STOCK BY MAJOR FINANCIAL INSTITUTIONS 1960-1969 (MILLIONS OF DOLLARS)

Year	Non-Insured Private Pension Funds	Open-End Investment Companies	Life Insurance Companies	Fire and Casualty Companies	Total Purchases and Sales
1960	3,280	4,785	605	[a]	8,670[1]
1961	4,610	6,710	975	[a]	12,295[1]
1962	4,200	6,415	790	1,150	12,555
1963	5,315	7,240	940	1,310	14,805
1964	6,480	8,655	1,215	1,545	17,895
1965	8,145	11,695	1,585	1,735	23,160
1966	9,775	19,685	1,935	1,725	33,120
1967	15,690	28,250	2,560	2,145	48,645
1968	20,105	38,590	4,650	3,890	67,235
1969	25,500	41,915	5,745	6,660	79,820

Source: Securities and Exchange Commission, quoted in New York Stock Exchange Fact Book (1970), p. 48.

[a]Not available.

[1]Does not include fire and casualty companies.

CHAPTER VIII

THE STRATEGIES ADOPTED BY THE REGIONAL EXCHANGES TO COUNTERACT THE EFFECTS OF THE BAN ON GIVE-UPS

In Chapter VII, the fact was noted that volume on three of the major regional exchanges increased in 1969, while volume on two others declined. In this chapter, the strategies adopted by the regional exchanges to offset the expected decline arising from the prohibition of the customer-directed give-up and the volume discount will be outlined.

Strategy of the Pacific Coast Stock Exchange

Volume of trading totalled 172 million shares in 1969, approximately 20 per cent more than the 143 million shares traded in 1968. Some of the major reasons for this increase are as follows:

Increase in new listings. New securities admitted to trading in 1969 amounted to 121 compared with 83 in 1968. These new issues accounted for almost 10 per cent of the total 1969 volume. At the end of 1969 the Pacific Coast Exchange had 831 securities available for trading, "which account for at least 70 per cent of the combined trading volume of all Exchanges in the United States."[1] Of the 831 issues, 606 were dually traded with

[1] Pacific Coast Stock Exchange, 1969 Annual Report, p. 2.

the NYSE, 170 with the AMEX, and 55 were listed exclusively on the Pacific Coast Stock Exchange. These 55 issues accounted for 26 per cent of 1969 share volume, compared with 20 per cent in 1968.

Increased membership. In 1969, the number of authorized memberships was increased to 220 from 200. The number of memberships outstanding increased to 206 from 179, a net gain of 27. Member firms increased from 147 in 1968 to 170 in 1969. Of the 206 memberships outstanding at the end of 1969, 156 were owned by member firms of the NYSE and/or the AMEX; the remaining 50 were sole member firms of the Pacific Coast Stock Exchange. At the end of 1969, seat prices were at a record high of $70,000, up from $55,000, while prices of seats on all other major exchanges declined.

Computer processing systems. These systems are regarded as among the most advanced in the industry. The COMEX system was introduced, which is a computerized order handling system for the automatic execution of odd-lot market orders. Another innovation is the net-to-net system, which regulates clearance of all listed and over-the-counter transactions between member firms. This system provides a daily record of all securities positions and balances, as well as a continuing inventory, and eliminates a great deal of off-setting trades and other paperwork.

Other observations. The Pacific Coast Stock Exchange has always had a unique advantage over the other exchanges. Because of its location it can provide longer trading hours, and it is the only major exchange that remains open for several hours after the eastern markets have closed.

In 1969, block transactions accounted for 36 per cent of total volume on the Pacific Coast Exchange, up from 32 per cent in 1968. Table 41 shows the breakdown of block transactions for 1969.

TABLE 41

PACIFIC COAST STOCK EXCHANGE
BLOCK TRANSACTIONS FOR 1969

Units (000's of Shares)	Number of Transactions	Per Cent of Total Volume
1 - 5	12,363	12.0
5 - 10	1,529	5.0
10 and over	1,397	19.0
Total	15,289	36.0

Source: Letter from Philip L. Thomas, Vice-President, Pacific Coast Stock Exchange, April 14, 1970.

> One obvious reason for trading blocks on the PCSE is the absence of New York State and City franchise taxes, an advantage the exchange has only recently begun to exploit. Too many block trades were automatically going through New York, Thomas P. Phelan, Exchange president, points out, which can be executed on the PCSE at the same price - but without the local taxes. With this in mind, the exchange embarked on a campaign to encourage members to trade "locally" and, as the recent statistics indicate, these efforts are meeting with some success.[2]

[2]"Regional Exchanges Come of Age," ISM, December 1969, p. 16.

In 1965, the Pacific Coast Exchange admitted a mutual fund affiliate to membership. By the end of 1969, seventeen institutional members which were affiliates of mutual funds had been admitted to membership. Some of the parent companies are The Dreyfus Corporation, Investors Diversified Services, Inc., Waddell and Reed, Inc., Channing Company, Inc., Equity Funding Corporation of America, and City Investing Company. So far, only mutual fund affiliates whose parent companies distribute through captive sales organizations have been admitted. Moreover, the Pacific Coast Exchange permitted three British brokerage firms to become members. In 1969, the Exchange permitted a subsidiary of a mutual fund to operate a specialist post on the floor. The obvious advantages to the Exchange from this arrangement are: (1) the backing of a fund organization with billions of dollars in assets should help to stabilize markets and also to swing some weight from the New York exchanges to the PCSE; (2) it should provide further impetus to block trading on the West Coast; and (3) specialist posts are usually a profitable operation, and this could well entice other mutual fund affiliates to follow suit.[3]

Volume on the Pacific Coast Stock Exchange had never really been affected by the ban on give-ups. According to Thomas P. Phelan, President of the Pacific Coast Exchange, a major reason for increased volume is that member firms "that have been selling mutual fund shares out here are getting direct orders.

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[3] Ibid., p. 17.

Previously, they had been getting give-ups by check from the executing brokers in New York."[4] Finally, in the words of Philip L. Thomas, Vice-President of the Exchange, "as evidenced by our volume figures, the give-up ban has not caused a decline in volume on the PCSE."[5]

Strategy of the Midwest Stock Exchange

Among the regional exchanges, the Midwest Stock Exchange was the only one which did not permit its members to split commissions with non-members. It thus followed the pattern of the NYSE and AMEX which had a similar prohibition. Because of its prohibition against fee-splitting, any possible decline in 1969 volume could not be attributed to the abolition of the customer-directed give-up. In 1969, however, volume on the Midwest Exchange increased to 146 million shares from 141 million in 1968. Despite the increased share volume, a decline occurred in the dollar value of shares traded; dollar value for 1969 was $6 billion compared to approximately $6.2 billion in 1968.

Some of the innovations introduced by the Midwest are:

1. Permission for member firms to sell all conventional forms of life insurance. The Midwest Stock Exchange

[4] "The Little Boards: Fee-Splitting Ban Cuts Stock Trading Sharply on Regional Exchanges," Wall Street Journal, January 9, 1969, pp. 1 and 7.

[5] Letter from Philip L. Thomas, Pacific Coast Stock Exchange, April 14, 1970.

President Michael E. Tobin stated that "it is our intention, in allowing member firms also to sell life insurance, to make it possible for them to offer a well rounded, full service financial program to their individual and institutional customers."[6]

2. Although the Midwest Exchange, for many years, had several members affiliated with institutional investors, these affiliates were not allowed to transact business for the institutions. On December 16, 1969 the governors approved a rules change that apparently would permit institutions to become members of the exchange. Under the rules change, the subsidiary of the mutual fund "would have to meet certain conditions, such as matching all commission dollars from fund portfolio transactions with commission dollars generated from public retail business on a dollar-for-dollar basis."[7] At present, no subsidiaries of mutual funds are members of the Midwest Stock Exchange.

3. The introduction of the SCAN (Service Corporation Accounting Network) system offers broker-dealers one of the most sophisticated, automated and computerized

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[6]"Regional Exchanges Come of Age," ISM, December 1969, p. 15.

[7]"Midwest Board's Governors Vote to Allow Institutional Members; Action is Opposed," Wall Street Journal, January 2, 1970, p. 6.

back-office systems in the country.

According to President Tobin, the philosophy at the Midwest Exchange is to use the exchange to foster the small to medium-sized firm, since the regional firm can and should survive and grow. Finally, in the words of Gerald A. Cicero, director of the marketing department of the Midwest Stock Exchange, "there has been no particular impact on the Exchange. Volume in 1969, after the ban, was above 1968 volume. The effect has been on member firms, possibly."[8]

Strategy of the P-B-W Stock Exchange

In 1969, the Philadelphia-Baltimore-Washington Stock Exchange showed the largest percentage increase in share volume among the regional exchanges. When the author visited the P-B-W in February, 1970, exchange officials he interviewed stated quite emphatically that the ban on give-ups had proven a boon to the exchange's business.

Prior to the ban, one of the major reasons for the rapid growth in share volume was the mergers which took place with the former Baltimore and Washington Exchanges. In addition the P-B-W signed associate membership agreements with the Pittsburgh, Boston, Montreal and Cincinnati Stock Exchanges. At the end of 1969 the Pittsburgh Stock Exchange was merged into the P-B-W.

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[8] Comments from a questionnaire completed by Gerald A. Cicero, director of the Marketing Department of the Midwest Stock Exchange, June 24, 1970.

Prior to the merger, the associate membership agreement with the Pittsburgh Stock Exchange had proved extremely rewarding to the P-B-W. Shares originating in the Pittsburgh Stock Exchange but executed on the P-B-W for the five year period 1964-1968 were:

1968 - 3,906,000 shares
1967 - 3,367,000 shares
1966 - 2,551,000 shares
1965 - 1,601,000 shares
1964 - 1,348,000 shares

The major reasons for the significant increase in share volume on the P-B-W were (1) the splitting of seats two for one in December of 1968; and (2) permitting institutions to become members of the exchange. Among the institutions which have become members of the P-B-W are Connecticut General Life Insurance Company, Dreyfus Corporation, INA Trading Corporation, and Kansas Cities Securities, a subsidiary of Waddell and Reed, a leading captive sales fund group.

> Liquidity is no problem because in the case of large blocks of stock both the sale and purchase (a so-called cross) are arranged before hand and then executed on the floor of the exchange.[9]

In Table 39 of Chapter VII block trading statistics of the regional exchanges were reviewed. Block transactions as a per cent of total volume increased to approximately 51 per cent

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[9]"Regional Exchanges Come Out of the Sticks," Business Week, January 3, 1970, p. 74.

in 1969 from 37.5 per cent in 1968. The increase can certainly be attributed to the increase in new members, especially the institutional ones.

In addition to the reasons cited above for the increase in share volume, the P-B-W in 1969 conducted transactions in 873 securities. Of this amount, 107 were solely listed, 70 dually traded with the AMEX. In addition, the P-B-W offered trading privileges in 678 unlisted issues, of which 600 were NYSE stocks.[10]

Strategy of the Boston Stock Exchange

In 1969, volume declined to 23.4 million shares from 42.4 million in 1968, a drop of approximately 45 per cent. Only the Detroit Stock Exchange fared worse. While the Boston Exchange had anticipated the ban on customer-directed give-ups would result in decreased orders, it never really expected that volume would decline to such an extent. To offset the expected decline, the Exchange adopted the following measures:

1. On October 9, 1968 it split the authorized number of seats from 112 to 224. According to James E. Dowd, President of the Exchange, ten seats are held in the treasury; the remaining 214 seats are divided among 181 members, some of whom hold two seats. For tax or other reasons, the second seats have not been sold. When the

[10]George Hender, private interview held at the P-B-W Stock Exchange, Philadelphia, Pennsylvania, February, 1970.

Governors of the Boston Stock Exchange voted a split of seats, they fixed the price of the second seats at $14,000 where it will remain until all of the 214 available seats are sold.[11]

2. The acceptance of foreign seatholders. In December, 1968, the Exchange accepted as a member a representative of German-American Securities, a wholly owned subsidiary of the Dresdner Bank of Frankfurt, Germany. Subsequently, the Exchange accepted other members representing Swiss, French and Japanese interests. President Dowd states that the foreign memberships have been extremely successful.[12]

Despite the measures discussed in the above paragraph, a tremendous decrease in trading volume occurred in 1969. Possibly the major reason for decline was that unlike the Pacific Coast and P-B-W Stock Exchanges, the Boston Exchange never permitted subsidiaries of mutual funds, banks or insurance companies to become members. In addition, before the ban became effective, lead brokers were able to find the other side of a trade among one of the many financial institutions in Boston, and frequently crossed the block order on the Boston Exchange. President Dowd

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[11] Letter from James E. Dowd, President of the Boston Stock Exchange, February 5, 1970.

[12] *Ibid.*

has estimated that volume of that kind in 1969 was 30 per cent of what it used to be in prior years.[13] While the Pacific Coast and P-B-W Exchanges were able to cushion some of the impact of the give-up ban through business produced by affiliates of institutions, the Boston Exchange could not do the same.

President Dowd does not foresee any change in the policy of the Exchange against institutional membership except perhaps to the limited extent proposed by the Midwest Stock Exchange. Mr. Dowd has stated that

> . . . there is no question that the tremendous increase in volume on the Boston Exchange during 1967 and 1968 was accounted for by the customer-directed give-up. Since its abolition, we have been studiously attempting to find ways and means of attracting new business and listings. The splitting of the seats and the acceptance of foreign members are two steps in this plan.[14]

Since most of the new members are mutual fund selling organizations, reciprocal business may be obtained directly through orders executed on the Boston Stock Exchange instead of via the give-up.

Strategy of the Detroit Stock Exchange

Of all the regional exchanges, the Detroit Stock Exchange was most severely hurt by the ban on customer-directed give-ups. Unlike the other regional exchanges which quickly adopted measures to counteract expected decline in trading volume, the

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[13] *Ibid.*

[14] *Ibid.*

Detroit Stock Exchange moved much slower and with much less success. Among the measures eventually adopted were:

1. Permitting institutional members of the National Association of Securities Dealers and SECO members to share in commissions when they turn over a trade for execution by a member of the Detroit Exchange. This rule became effective in April, 1969.[15]
2. The introduction in August, 1969, of a specialist system. At present there are two posts; each post has one specialist who handles 15 stocks. Eventually the Exchange hopes to have specialists in all stocks.[16]

In addition to the above measures, the Detroit Stock Exchange hopes to upgrade the present listing of issues, adding securities which are more active. The Exchange also hopes to obtain more local issues and will emphasize this aspect. Like the other exchanges, the Detroit Exchange has become highly automated and will offer its computer services to firms on a time-sharing basis. Finally, the Exchange hopes to introduce "cabinet securities", which simply means deactivating stocks in which there is little trading. This will be beneficial to the sole odd-lot dealer firm which will not have its capital tied up in

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[15] Edward Denny, private interview held at the Detroit Stock Exchange, Detroit, Michigan, February, 1970.

[16] _Ibid._

slow moving stocks.[17]

Perhaps the major reason for the sharp decline in 1969 volume is the reluctance of the Detroit Exchange to permit any form of institutional membership. According to Mr. Edward Denny, Executive Vice-President, the Detroit Stock Exchange is not actively seeking subsidiaries of mutual funds and other institutional investors because (1) the members of the exchange are against such membership, and (2) the constitution of the exchange will have to be amended to permit such membership.[18]

Other Regional Exchanges

The Pittsburgh Stock Exchange merged with the P-B-W Stock Exchange at the end of 1969. Ironically, it was heavy trading, not a decline in volume that caused the merger. As was pointed out earlier, there was only one block trade on the Pittsburgh Stock Exchange in recent years, so it was not affected by the ban on give-ups. The main reason for the merger was the inability of the members to devote sufficient time to the exchange, because of time involved in running their own brokerage firms.[19]

For years the Cincinnati Stock Exchange has been steadily losing volume. When the author interviewed Mr. Charles Steffens,

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[17] Ibid.

[18] Ibid.

[19] James V. Kissane, private interview held at the Pittsburgh Stock Exchange, Pittsburgh, Pennsylvania, February, 1970.

President of the Exchange, he was told that the two major reasons for the decline of trading volume in 1969 were: (1) the decision of Hayden, Stone, Inc., the major odd-lot dealer in the exchange to give up odd-lot books and send all orders to New York for execution; and (2) the inability of Brown Securities Company to continue as the specialist in 80 issues.[20]

Some Final Reflections

Despite the predictions of chaos and complete ruination by the regional exchanges, with the exception of the Boston and Detroit Stock Exchanges, the abolition of the customer-directed give-up did not materially affect operations on the majority of the regional exchanges. On the Pacific Coast, Midwest and P-B-W Exchanges volume actually increased despite a decline in total volume of trading on all exchanges. Increased trading on the Pittsburgh Stock Exchange was mainly responsible for its merger with the P-B-W Exchange. The decline of the Cincinnati Stock Exchange was caused by factors other than the abolition of give-ups.

Only on the Boston and Detroit Stock Exchanges can the decline in volume be partially attributed to the prohibition of customer-directed give-ups. The fact was pointed out that the

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[20] Charles Steffens, private interview held at the Cincinnati Stock Exchange, Cincinnati, Ohio, February, 1970.

reluctance of these exchanges to permit any form of institutional membership was probably the single major factor for the decline. In many ways, the prohibition of give-ups proved a boon to the exchanges as it forced them to implement changes which were necessary. Dynamic and innovative management by the Pacific Coast and P-B-W Exchanges resulted in record volume of trading in 1969. These exchanges were not afraid to face reality. Apparently the regional exchanges need institutional members if they are going to survive and prosper. The extreme differences in trading volume on the Pacific Coast and P-B-W Exchanges on one hand, and the Boston and Detroit Exchanges on the other, bear testimony to this point.

PART IV

SUMMARY AND CONCLUSIONS

CHAPTER IX

SUMMARY

In this chapter the purpose of the study will be briefly reviewed and a restatement of the problem made. The methodology employed will be outlined, and a summary of the developments of the various chapters of the dissertation will be restated.

Purpose of the Study

The purpose of the research carried out was to try to determine the impact of the prohibition of the customer-directed give-up on mutual fund retailers and the major regional exchanges. As stated in a prior chapter, the research was not undertaken to specifically prove or disprove predictions made by various organizations and individuals that the prohibition would be disastrous to certain members of the securities industry. Rather, the purpose was to review all information in an unbiased manner, and then compare the actual results with those predicted.

Restatement of the Problem

Many individuals predicted that if customer-directed give-ups were abolished, one of the results would be a drastic shift in income from smaller to larger brokerage houses. Numerous small member and non-member firms would find operations unprofitable and would eventually be forced out of business. Another prediction was that the abolition of give-ups would prove disastrous, not only to the continued growth of the regional exchanges, but to their actual survival. Yet another prediction was that the closing of many small brokerage firms coupled with inefficiently operating regional exchanges would be detrimental to the investing public, especially those investors who depended on small brokerage firms for execution of their orders.

Research Methodology

To determine the impact of the prohibition of the customer-directed give-up on retailers of mutual funds, a questionnaire survey was undertaken. Using the SEC's computer listings of registered broker-dealers, a statistically selected sample was obtained, and questionnaires were sent to 540 mutual fund retailers. A second questionnaire was sent to fund retailers not responding to the first request. Statistical tests were performed to determine whether there had been a significant change between 1968 and 1969 in (a) gross income of mutual fund retailers, and (b) in income from mutual fund sales as a per cent of gross income. These two variables, in the author's opinion, appeared most pertinent in the attempt to determine the effects of the ban on mutual fund retailers.

To ascertain how much of an impact the abolition of give-ups had on major regional exchanges, the author visited several of the exchanges to obtain current information. For the exchanges not personally visited, the author communicated with responsible executives in writing and by telephone. The belief was held that changes in share and dollar volume between 1968 and 1969, block transactions for these two years, increases or decreases in exchange membership, and number of securities issues traded would be the most important variable to be examined in the determination of the impact of the prohibition of the customer-directed give-up on the regional exchanges.

Summary of the Chapters

In Part I, Chapter II, institutional trading and the growth of the mutual fund industry for the decade 1960-1969 were reviewed. The pertinent points of this chapter were:

1. Financial institution holdings of New York Stock Exchange listed stocks had increased from 12.7 per cent in 1949 to 24.1 per cent in 1969. Between 1959 and 1969, these holdings increased from 17.2 per cent to 24.1 per cent.
2. Institutions and intermediaries in 1960 were responsible for 24.3 per cent of the share volume on the NYSE, while in 1969 there was an increase to 41.1 per cent. In terms of public volume alone, institutions and intermediaries accounted for 31.4 per cent of NYSE share volume in 1960 and 54.4 per cent in 1969.
3. The market value of mutual fund holdings of NYSE listed stock increased from 3.8 per cent in 1959 to 6.3 per cent

in 1969; in dollar amounts the increase was from 11.6 billion to 39.8 billion.

4. On both the NYSE and AMEX there was a tremendous increase in block transactions during the past five years. Between 1965 and 1969, block volume as a per cent of total volume increased from 3.1 per cent to 14.1 per cent on the NYSE; on the AMEX between 1966 and 1969 the increase was from 1.0 per cent to 4.9 per cent.
5. Mutual fund assets in 1960 amounted to 17 billion dollars; in 1969 assets had grown to 48.3 billion dollars. The number of accounts during this period had grown from 4.9 million to 10.4 million.
6. Despite the bear market of 1969, mutual fund purchases of portfolio securities in that year were 24.8 billion dollars, almost 3 billion more than in 1968; net purchases in 1969 were approximately 2.7 billion dollars more than in 1968.

In Part I, Chapter III, the events leading to the prohibition of customer-directed give-ups were discussed. Pointed out was the fact that for many years prior to its proposed ruling on the give-up of commissions, the SEC had been aware of the relationship between the give-up and the rigidity of the minimum commission rate structure of the NYSE. The initial proposal of the NYSE relating to a volume discount was reviewed; in this proposal the NYSE also supported continuation of the customer-directed give-up on a limited scale. The proposed rule 10b-10 of the SEC was then examined; this rule would have prohibited the give-up of commissions which were directed by mutual funds, unless all amounts given up were returned to the funds.

In May of 1968, according to Securities Exchange Act Release No. 8324, the NYSE was requested to adopt a provisional revised commission rate schedule or as an alternative, the NYSE was requested to do away with minimum commission rates in excess of $50,000. Correspondence between the Chairman of the SEC and the President of the NYSE was examined; the fact was noted that the NYSE decided, rather surprisingly in view of its previous opinions, that a gradual elimination of the customer-directed give-up would not be suitable, because the intricate and devious arrangements through which give-ups took place involved the use of unrelated trades. The NYSE decided that only a complete prohibition would prevent the flagrant continuation of give-up practices.

The legal action taken by the Independent Broker-Dealers' Trade Association against the Securities and Exchange Commission was reviewed. The IBDTA claimed that the directive of the SEC to the NYSE regarding give-ups constituted an unlawful order because no opportunity for a hearing was given, and a hearing is required by the Securities Exchange Act of 1934. The IBDTA was unsuccessful in its attempt to force the SEC to set aside its request or directive to the NYSE relating to the revised commission structure. Finally, the fact should be noted that in its special bulletin to members on the proposed amendment to Article XV of its Constitution, the NYSE specified that the amendment calling for a prohibition of customer-directed give-ups and a volume discount, was necessary for the preservation of the minimum commission structure.

In Part II of the dissertation, the studies of the NASD and IBDTA together with the questionnaire survey of the author were reviewed. In Chapter IV it was mentioned that when the NASD published the results of its study, the SEC was somewhat skeptical of the findings. The SEC wished to examine the raw data of the NASD study, but this was impossible since the data had been destroyed. Also pointed out was the fact that the NASD study inferred that all mutual fund retailers received give-ups; in no part of the study was it stated that many never received a dollar of split commissions, simply because the volume of their mutual fund sales did not justify give-ups being directed to them. Only the large retailers of mutual funds received substantial give-ups; broker-dealers with incomes under $100,000 received either no give-ups or insignificant amounts. If the elimination of an insignificant amount of income was sufficient to throw the average dealer from a position of profit to one of loss, one wonders how efficiently the operations of the average dealer could have been in the first place. Also noted was the fact that the NASD erred in its assumption that no costs were attached to income derived from the give-up. The results of the author's survey showed that mutual fund retailers did allocate costs to give-up revenue and reduced these costs when customer-directed give-ups were eliminated.

The study of the Independent Broker-Dealers' Trade Association was not a professional or sophisticated study, nor was it meant to be, according to the president of the Association. The important findings of this study appear to be that many small brokerage firms do not consider the SEC or the NASD to be operated efficiently. These firms feel that both organizations were not really interested in small firms in the securities industry.

Chapter V dealt with the questionnaire survey of the author. A statistically selected sample of 540 mutual fund retailers were surveyed to determine the impact of the prohibition of the customer-directed give-up on their operations. The two most significant variables tested were (1) gross income for 1968 and 1969, and (2) income from mutual fund operations as a per cent of gross income for 1968 and 1969. Statistical tests were performed to determine if any significant change had taken place in these variables between 1968 and 1969. As was noted before, the purpose of the author's questionnaire was not to try to prove or disprove the assertions of the NASD and other associations that the elimination of give-ups would result in tragic consequences for many firms. Neither was the study an attempt to justify the actions of the SEC or the NYSE. Instead, the study should be considered purely as a piece of empirical research to determine the results, beneficial or detrimental, of legislation which created a considerable amount of furor in the securities industry.

Among the major findings of the study were: (1) many firms were not affected by the prohibition of give-ups, either because they had never received give-ups, or because the amounts received had been insignificant; and (2) many had made changes in advance to counteract the loss of income resulting from the prohibition. Some of the more important changes were: (a) a decrease in commissions to registered representatives selling fund shares; (b) an increase in sales of life insurance and over-the-counter securities; (c) the introduction of block trading departments; (d) membership on the regional exchanges; (e) mergers with other companies; (f) a reduction in office and sales personnel; (g) a decline in services to clients, and a marked decrease in extra services; and (h) an increase in sales of mutual fund shares which paid higher dealer allowances.

Many firms indicated that the ban had been detrimental and was directly responsible for a decline in net income. This claim seemed exaggerated, since almost all of the firms surveyed were involved in security transactions, other than the sale of mutual fund shares. One may recall that 1969 was not the best of years for the securities industry. Therefore the total decline in the securities markets must be taken into account, and must have contributed to any loss of income suffered by the firms in the sample that was surveyed.

Part III of the dissertation dealt with the impact of the abolition of customer-directed give-ups on the regional exchanges. In Chapter VI, the reactions of the major regional exchanges to initial proposals of the NYSE and SEC were reviewed. A consensus of opinion existed among the regional exchanges that the proposals of the NYSE were not justified and plainly anti-competitive, since they would result in the NYSE having a virtual monopoly of exchange business. Some of the regional exchanges stated that the NYSE proposals were primarily directed at the regional stock exchanges because of the competition with which they threatened the NYSE; if the proposals were adopted, the growth potential of the regional exchanges would be disastrously affected and the very existence of these exchanges would be threatened.

Regarding the SEC's proposal, the regional exchanges in the majority considered it impractical and inequitable. The P-B-W, for example, found fault with the proposed Rule 10b-10 because it seemed to be based on the unsound assumptions that the person receiving the give-up either incurred no cost, or rendered no service in connection with the order from which the give-up was derived. Both the NYSE and the NASD also erroneously made the same assumptions as the SEC. Among the other comments made by the regional exchanges relative to the SEC proposal were: (1) adoption of the proposal would cause a large reduction in the volume of transactions on the regional exchanges; and (2) adoption of the proposal would inevitably lead to many forced mergers of brokerage firms.

In Chapter VII, the growth of the regional exchanges for the decade 1960-1969 was examined. Among the more pertinent findings of this chapter were: (1) despite a decline in total volume of trading on all registered exchanges in 1969, the regional exchanges' share of total volume increased to 9.0 per cent from 8.3 per cent in 1968; (2) on the Pacific Coast, Midwest and the P-B-W Exchanges, which account for the major portion of all regional exchange transactions, there was a substantial increase in 1969 volume; and (3) block transactions on all the major regional exchanges, excepting the Detroit Stock Exchange, increased in 1969.

Chapter VIII reviewed the strategies of the various regional exchanges which were adopted to counteract the effects of prohibiting give-ups. Noted was the fact that volume of trading on the Pacific Coast Stock Exchange increased by 20 per cent in 1969. Some of the major reasons of the increase were: (1) an increase in new listings of securities; (2) an increase in exchange membership; (3) the installation of advanced computer processing systems; (4) the increased number of institutional members which were affiliates of mutual funds; and (5) the increase in direct orders to member firms selling mutual fund shares.

Some of the innovations of the Midwest Stock Exchange were: (1) permission for member firms to sell all conventional forms of life insurance; and (2) the approval by the governors of the exchange in December, 1969, of a rules change that would apparently permit institutions to become members of the exchange.

The major reasons for the very significant increase in share volume on the P-B-W during 1969 could be attributed to (1) the splitting of membership seats, two for one in December of 1968; (2) permitting institutions to become members of the exchange with the resultant increase in block trading; and (3) the large number of issues in which trading is conducted.

Although the Boston Stock Exchange split the authorized number of seats from 112 to 224 in October, 1968, and began to accept foreign seat holders in December, 1968, a substantial decline in trading volume occurred in 1968. Possibly the major reason for the decline in trading was that unlike the other major regional exchanges, the Boston Exchange never permitted subsidiaries of mutual funds, banks or insurance companies to become members. Mr. Dowd, the President of the Boston Stock Exchange, has stated that the reason for the tremendous decline in volume during 1969 was because of the elimination of the customer-directed give-up.

The Detroit Stock Exchange permitted institutional members of the NASD and SEC to share in commissions when they turn over a trade for execution by a member of the Exchange. This innovation became effective in April, 1969. The Detroit Stock Exchange also introduced a specialist system in August, 1969. Despite these innovations, the decline in the 1969 trading volume was very substantial. The major reason for the decline was the reluctance of the Exchange to permit any form of institutional membership.

On the other two major regional exchanges, the Pittsburgh and Cincinnati, the elimination of the customer-directed give-up was inconsequential. At the end of 1969, the Pittsburgh merged with the P-B-W Stock Exchange. Ironically, heavy trading, not a decline in volume, caused the merger. Volume of trading on the Cincinnati Stock Exchange had been declining for a number of years because of internal problems with its odd-lot and specialist systems.

CHAPTER X

CONCLUSIONS

As a preface to the author's conclusions, the comments of the United States Department of Justice on the proposed SEC Rule 10b-10 and on the proposal of the NYSE to revise its commission rate structure will be briefly stated. The comments of the NYSE to the SEC proposed Rule 10b-10 will also be briefly given for it must be shown that initially the NYSE had stoutly defended the use of give-ups as a most efficient and economical tool. The author feels these comments, especially those of the Justice Department, would give the reader a better understanding why the NYSE changed its defense of the give-up and also why legal action was taken by the Independent Broker-Dealers' Trade Association against the SEC for improperly directing the NYSE to revise its commission rate structure.

In its comments on the SEC's proposed Rule 10b-10, the President of the NYSE stated that give-ups constituted a highly flexible means of compensating various brokerage houses for various constructive services within the framework of a single commission. Give-ups assumed increasing importance as the value of market research and the size of institutional orders increased. The NYSE further stated that give-ups were a most efficient and economical means of enabling large investors to meet their obligations to many brokers, and that the practice of directing distribution of a part of commissions relative to mutual fund sales was proper and desirable.[1] Despite these statements, on August 8, 1968 in a letter to the chairman of the SEC, the President of the NYSE later stated that a gradual elimination of customer-directed give-ups would not be suitable because the intricate and complex arrangements through which customer-directed give-ups took place involved the use of unrelated trades. The NYSE decided that only a complete prohibition would prevent the flagrant continuation of give-up practices.[2]

Perhaps the reasons for the complete change in opinion by the NYSE will be found in the comments made by the United States Department of Justice. The following points were the most pertinent made by the Justice Department:

1. The Justice Department raised the question about whether rate fixing was required or justified by the objectives of the Securities Exchange Act. The maintenance of an effective auction market did not appear to justify the fixing of minimum commission rates by the NYSE. In the opinion of the Justice Department, little likelihood

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[1] Selected Comments on SEC Proposed Rule on Give-Ups and NYSE Proposal on Commission Rates (Chicago: Commerce Clearing House, Inc., 1968), p. 44.

[2] Independent Broker-Dealers' Trade Association, Oxford Securities, Inc., and James C. Butterfield, Inc., v. Securities and Exchange Commission No. 22,552, United States Court of Appeals for the District of Columbia Circuit, 40 (1968).

seemed to exist for any significant risk of destructive price levels or adverse consequences to the operations of the NYSE from price competition; effective competition had been taking place for institutional business, but because of the minimum rate structure it took the indirect form of give-ups and reciprocal business. The Justice Department believed that rate fixing was unnecessary for institutional trading and large transactions, but it did concede that maximum, not minimum rates, may be warranted for the protection of the small investors.[3]

2. The Justice Department considered the proposed volume discount of the NYSE a move in the right direction, but insisted that rate competition was a more flexible solution. It strongly objected to the NYSE proposals to limit give-ups and prohibit reciprocal practices, without any assurance that rates would be set at a competitive level. Because of the unrealistic rates of the NYSE, the Justice Department stated that give-ups and reciprocal business appeared to be the only means by which some investors could obtain the services of NYSE member firms at a reasonable fee. The Justice Department finally

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[3]Comments of the United States Department of Justice, Inquiry Into Proposals to Modify the Commission Rate Structure of the New York Stock Exchange. SEC Release No. 8239 as quoted in Selected Comments on SEC Proposed Rule on Give-Ups and NYSE Proposal on Commission Rates (Chicago: Commerce Clearing House, Inc., 1968), pp. 16-31.

concluded by stating that while the practices of give-ups and reciprocal business raised problems, the only solution was to revise the rate structure which caused them. It suggested that the SEC should take appropriate action to confine the NYSE rate fixing within the limits required by the Securities Exchange Act and the antitrust laws.[4]

In view of the Justice Department's extremely strong dislike of the NYSE commission rate structure, the decision of the Exchange to prohibit customer-directed give-ups and institute a volume discount does not seem strange. Again the fact should be noted that in its special membership bulletin to its members on the proposed amendment of Article XV of the Constitution, the NYSE specified that the amendment was necessary for the preservation of the minimum commission structure. The NYSE was determined that its minimum commission rate structure should not be tampered with and was prepared to change its initial views on the give-ups to mollify the Department of Justice and the SEC. The author's conclusions that follow show that the predictions made by the NASD, the regional exchanges and others regarding the disastrous effects of eliminating the customer-directed give-up did not really materialize. However, a crucial point is not so much

[4]Ibid., pp. 16-31.

that the give-up was prohibited, but the manner in which the prohibition took place. The author agrees with the Independent Broker-Dealers' Trade Association that the NYSE was coerced into the abolition of the customer-directed give-up, and believes that its legal action against the SEC was justifiable despite claims by the SEC that the interim rate schedule, including the ban on give-ups, was voluntarily adopted by the NYSE and was not imposed on the Exchange by the SEC.

The results of the statistical tests indicated that the change in the distribution of income from mutual fund operations between 1968 and 1969 was not significant. The tests also indicated that changes in gross income of the firms surveyed were insignificant. Based on the sample results, must it be concluded that all mutual fund retailers were no worse off in 1969 than they were in 1968? This conclusion may not be proper for two reasons: (1) A one hundred per cent return on the questionnaires mailed did not occur and as a result, the statistical purist would find such a conclusion improper; and (2) because of the size of the class limits of the two income variables, gross incomes of firms may have declined, yet not sufficiently for them to have moved to another class limit. For example, a firm in the \$100,000 - \$200,000 category may have grossed \$180,000 in 1968 and \$120,000 in 1969, but this change would not have been taken into account. Again, a firm may have received 85 per cent of its gross income from mutual fund sales in 1968, and only 71 per cent in 1969, but still it would have remained in the same class limit.

This limitation was recognized by the author and members of his committee, but the belief was held that having an innumerable amount of class limits would detract from the compactness of the questionnaire, and seriously threaten the success of the response.

Is the conclusion, then, that mutual fund retailers have been seriously hurt by the elimination of customer-directed give-ups? On the contrary, the comments made would seem to indicate that a great many firms were (1) either not affected because they never received give-ups, or had received insignificant amounts; and (2) had made changes to compensate for the income lost from the elimination of give-ups. Although these changes were mentioned in Part II, they are of sufficient importance to merit repetition:

(a) A decrease in commissions to registered representatives selling fund shares.

(b) An increase in sales of life insurance and over-the-counter securities.

(c) Introduction of block trading departments.

(d) Membership on the regional exchanges.

(e) Merging with other firms.

(f) A reduction in office and sales personnel.

(g) A decline in services to clients, and a marked decrease in extra services.

(h) Sales of mutual fund shares which paid higher dealer allowances.

Many respondents to the questionnaire indicated that the ban had been detrimental and was directly responsible for a decline in net income. Somehow, this claim seems exaggerated, especially since almost all of the firms surveyed were involved in security transactions, other than the sale of mutual fund shares. Certainly 1969 was not the best of years for the securities industry. Therefore the total decline in the securities markets must be taken into account, and must have contributed to any loss of income suffered by the firms in the survey. The following comment from one of the questionnaires was quoted in Part II; because it best illustrates what has really occurred it is worth repeating.

> It is not a loss of customer-directed give-ups which have caused this industry problems, rather the severe reduction of trading volume and the associated decrease in value in the securities traded. Firms geared up too late to meet the volume crisis in 1968-1969, and once again are too late in reducing fixed cost levels in proportion with the reduced volume. The pricing structure in this business is antiquated. It is currently related to number of shares and price rather than to cost. The proposals to restrictive commissions rates currently before the SEC is definitely a step in the right direction.

If the comments of the respondents are to be taken at face value, then perhaps an unfortunate aspect of the ban is its effect on the investing public, since the most recurrent comments were: (1) services rendered to the investing public have declined; (2) mutual fund retailers are now pushing mutual fund shares which pay a higher dealers' allowance; (3) more emphasis was being placed on the sales of common stock, bonds, and life insurance; (4) commissions paid to representatives selling mutual fund shares had been reduced; and (5) many employers of mutual fund retailers had been released, and the training of those employees retained had been severely curtailed.

Each one of these comments will be reviewed to determine the possible harmful effects on the investing public.

1. Many respondents to the author's questionnaire stated that they reduced services to their customers. Most of the respondents, however, were not very specific as to the exact nature of the services reduced. Some students of the market, including the author, have sometimes wondered whether these services were not exaggerated, in fact, more mythical than actual. An interesting point to note is that in 1969, sales of mutual fund shares were only $102 million less than in 1968. The result was an increase of $75 in net capital during 1969. In addition, the number of mutual fund accounts increased from 9,080,000 in 1968 to 10,392,000 in 1969. If services had been curtailed so drastically, the increase in the number of mutual fund shareholders in 1969 is extraordinary, especially when one takes into account the poor state of

the securities industry in 1969.

2. In addition to the respondents who claimed that mutual fund retailers were pushing fund shares with a higher dealers' allowance, many individuals interviewed by the author, including the President of the Independent Broker-Dealers' Trade Association, stressed that this practice was indeed taking place. If these claims are true, then customers may be buying mutual fund shares that are not really suited to their needs. When one considers that the majority of mutual fund shares are sold through the efforts of salesmen, rather than through the spontaneous choice of customers, the question of sales ethics is now introduced. If mutual fund salesmen are misleading customers, then this is indeed tragic. However, there is a nagging doubt in the author's mind that the practice of pushing mutual fund shares with the highest dealer allowance did not materialize when the customer-directed give-up was abolished, but had been a part of the sales practices of the mutual fund industry prior to the abolition. This practice may have been accentuated by the abolition of give-ups, but this is a subjective view; a great deal of research would be necessary to validate the claim that since the give-up was abolished, mutual fund retailers have been emphasizing mutual shares that pay a higher dealers' allowance. The

author feels that any such research may prove fruitless since salesmen of any type always seem able to justify their sales practices.

3. As regards the emphasis placed on sales of other securities, the author's contention is that brokerage houses may have been acting wisely, through intent or ignorance, since mutual funds in 1969 and 1970 certainly did not out-perform any of the major market indexes. In addition, the commissions paid by customers on mutual funds are higher than those on purchases of common stock and bonds. The only implication here is that a customer dealing in common stocks is more likely to have a faster turnover in his portfolio, than if his portfolio was composed solely of mutual funds.
4. If commissions paid to representatives selling mutual fund shares had been reduced, then this decrease may have spurred the salesman to increase their selling efforts; perhaps this increased effort resulted in the increased number of mutual fund accounts in 1969. Again this supposition is purely subjective. Perhaps the increased efforts of mutual fund salesmen were not beneficial to their customers, but to substantiate this hypothesis is not really possible.
5. Finally, the claim that training of employees of mutual fund retailers has been curtailed is open to doubt. Many

students of the market, including the author, firmly believe that the training procedures have always been suspect. The claim that the abolition of the give-up has accentuated this lack of training seems exaggerated.

The effects of the ban on the investing public is difficult to determine. From a purely subjective viewpoint, the author feels that based on the points discussed in the previous pages, the investing public, in its relations with mutual fund retailers, is not any worse off now than it was prior to the abolition of the customer-directed give-up.

The author's conclusion is that the death tolls prophesied by the NASD and others for retailers of mutual funds were premature. These predictions were based on three premises: (1) that all firms received give-ups; (2) that no costs were allocated to the receipts of give-ups; and (3) that firms which lost income from the elimination of give-ups would quietly fade away, without initiating changes to compensate for lost income. An examination of the comments shows quite plainly that all firms certainly did not receive give-ups. As one firm stated,

> . . . the funds wanted a large volume from us before they would give much in the way of give-ups. If anything, the ban may have helped us by causing a trend toward higher direct commissions of which we automatically receive our share.

While the NASD and others may not have allocated costs to give-ups, the mutual fund retailers certainly did, and their claimed reduction of services to clients bear out this fact. This comment was one of the most prevalent made by the respondents. Finally, the firms did not stay static, but made changes in their organization structures to offset any loss in income, and these changes were previously listed. Not all these changes were beneficial; it would appear from the comments, that joining regional exchanges did not prove to be the panacea to mutual fund retailers, notwithstanding claims of the regional exchanges.

Despite the predictions of chaos and complete ruination by the regional exchanges, the fact remains that with the exception of the Boston and Detroit Stock Exchanges, the abolition of the customer-directed give-up did not materially affect operations on the majority of the regional exchanges. On the Pacific Coast, Midwest and P-B-W Exchanges, volume actually increased despite a decline in total volume of trading on all exchanges. Increased trading on the Pittsburgh Stock Exchange was mainly responsible for its merger with the P-B-W Exchange. The decline of the Cincinnati Stock Exchange was caused by factors other than the abolition of give-ups.

Only on the Boston and Detroit Stock Exchanges can the decline in volume be partially attributed to the prohibition of customer-directed give-ups. The reluctance of these exchanges to permit any form of institutional membership was probably the single major factor for the decline. In many ways the prohibition of give-ups proved a boon to the exchanges as it forced them to implement changes which were necessary. Dynamic and innovative management by the Pacific Coast and P-B-W Exchanges resulted in record volume of trading in 1969. Clearly, regional exchanges need institutional members if they are going to survive and prosper. The extreme differences in trading volume on the Pacific Coast and P-B-W Exchanges on one hand, and the Boston and Detroit Exchanges on the other, bear testimony to this point.

What of the investing public and its relations with the regional exchanges since the abolition of the customer-directed give-up? Many changes have been implemented by the regional exchanges, and these changes include (1) increased membership on the Pacific Coast, P-B-W and Boston Stock Exchanges; (2) introduction of computer processing systems on the Pacific Coast and Midwest Exchanges; (3) increase in new securities listed on all the regional exchanges, particularly on the Pacific Coast and P-B-W Exchanges; and (4) the increased use of specialists on the Pacific Coast and Detroit Exchanges.

Because of these changes, which certainly were accelerated by the abolition of give-ups, the author believes that the general public was the net beneficiary. While no empirical evidence exists for this belief (and this belief is purely subjective), the majority of the changes made by the regional exchanges would appear to have resulted in more efficiently operating organizations. The regional exchanges, because of these changes, are able to compete much more vigorously with the national exchanges for public transactions. The end result can only be beneficial to the general public.

In a prior section the fact was stated that many broker-dealers had mentioned in their questionnaire replies that they were concentrating on mutual funds which paid the highest dealer allowances. This practice was also confirmed by the President of the Independent Broker-Dealers' Trade Association. An interesting study would be to compare sales of mutual funds with the highest dealer allowances in 1968 and 1969, and obtain reasons for any large fluctuations.

Another unanswered question is whether anyone has really benefited from the abolition of the customer-directed give-up. On the surface, mutual funds should have been the prime beneficiaries because of the volume discount, but if large orders are being broken down into many smaller ones, then the less efficient execution which would be expected to take place on many small orders may have nullified the anticipated savings from the volume discount. A study of the transactions of mutual funds in 1969 could provide the answer to the question posed in the preceding paragraph.

In addition to give-ups, many complex reciprocal practices have developed in connection with institutional trading. Institutional traders use a large part of commissions generated by their portfolio transactions for some form of reciprocity. Many banks insist on demand deposits in exchange for commissions. Insurance companies direct orders to brokers who buy insurance from them. Some corporate pension funds will not direct orders to brokerage houses which do not recommend purchase of the corporation's stock. A study of these reciprocal practices could prove rewarding since there are ethical and legal implications with regard to these practices.

Finally, another unanswered question is the importance of the NYSE minimum commission rate structure. Since the volume discount became effective in December, 1968, the SEC has held hearings on the commission rate structure. On several occasions the NYSE has proposed changes on the structure but on each occasion nothing permanent came of the proposals. Is the Department of Justice correct in its assertions that minimum commissions are undesirable, and that rate competition would be a more desirable solution to many of the industry's problems? This problem appears to be quite important and would certainly merit additional research.

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APPENDIXES

APPENDIX I

RELEASE NO. 8239 OF THE SECURITIES AND EXCHANGE COMMISSION AND MISCELLANEOUS CORRESPONDENCE

FOR RELEASE Friday, January 26, 1968

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.

Securities Exchange Act of 1934
Release No. 8239

ERRATA

The following changes should be made in the attached copy of Securities Exchange Act Release No. 8239;

(1) Page 2 - full paragraph 4, sentence 2. The phrase "institutional order" should read "institution".

(2) Page 3 - full paragraph 4, sentence 2. The phrase "on the floor" should read "off the floor".

(3) Page 9 - last sentence in carry-over paragraph from page 8 -- The term "and 23(a)" should be inserted following "15(c)(1) and (2)".

FOR RELEASE Friday, January 26, 1968

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

Securities Exchange Act of 1934
Release No. 8239

The Securities and Exchange Commission announced that the New York Stock Exchange has submitted for Commission comment and reaction the outlines of a proposal for certain revisions of its commission rate structure. A copy of that proposal is attached to this release. As described more fully below, the Exchange proposal generally contemplates (1) provision for a volume discount in commissions, (2) access to the exchange market for qualified nonmember broker-dealers through a professional discount, (3) recognition of limited customer directed "give-ups" of commissions to both members and nonmembers on New York Stock Exchange executions and limitations upon reciprocal business, (4) a prohibition of procedures by which institutional investors may recapture a portion of the commissions paid by them and (5) a requirement that the regional exchanges impose similar restrictions.

The Commission also announced that it has under consideration a proposal to adopt Rule 10b-10 under the Securities Exchange Act of 1934. The rule, essentially, would prohibit investment company managers from directing brokers executing transactions for an investment company to divide their compensation in any way with other brokers unless the benefits of such division accrue to the investment company and its shareholders. The rule would be adopted pursuant to the antifraud provisions of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 and certain provisions of the Investment Company Act of 1940.

Since the proposal of the Exchange as well as the proposed Commission rule would have significant impact upon New York Stock Exchange member firms, nonmember broker-dealers, institutional investors, other exchanges and the public, the Commission believes it appropriate that all interested persons have an opportunity to comment not only on the proposed Commission rule but also on the Exchange's proposal.

Both the proposed Commission rule and the proposal of the Exchange arise out of certain problems presented by the great increase in institutional investment and the complex and rapidly developing pattern of practices and procedures in the securities markets associated with that increase which are commonly referred to as "give-ups and reciprocal business." Proposed Rule 10b-10 is limited in scope. It assumes that present give-up practices will continue and accordingly deals primarily with the question of conduct by fiduciaries in that context. The New York Stock Exchange proposal is more far reaching and, particularly insofar as it involves a volume discount, suggests the possibility that the problem with which the proposed rule is concerned could be dealt with in a more direct and thorough-going way by changing the commission rate structure. For this reason and because in certain respects the proposed rule of the Commission and the Exchange proposal are inconsistent, the Commission further believes it appropriate to afford interested persons the opportunity not only to comment with respect to both the proposed rule and the Exchange proposal but to suggest, if they so desire, alternative means of dealing with the serious and difficult problems presented.

Any consideration, both of these proposals and of the practices and procedures to which they relate, must include careful attention to their impact upon competition, including competition among securities firms, competition among markets and competition among institutional investors. This is mandated by the antitrust laws and the policies underlying these laws. As the Supreme Court has pointed out, the Exchange commission rate structure includes a number of practices which would clearly violate the antitrust laws absent the Securities Exchange Act and notwithstanding the Securities Exchange Act the exchanges do not enjoy a blanket exemption from the antitrust laws. Nevertheless where the Commission has jurisdiction to review and pass upon particular Exchange activities, as it has in the area of commission rates under Section 19(b) of the Exchange Act, antitrust immunity may, under some circumstances, be implied. 1/ Such immunity would be implied to the extent necessary to reconcile the statutory scheme of the Securities Exchange Act with that of the antitrust laws. This necessarily contemplates that full consideration be given to the policies of the antitrust laws as well as those of the Securities Exchange Act in evaluating any aspect of the commission rate structure or any proposals for its revision. Whether or not the mere existence of Commission jurisdiction necessarily creates an immunity from the antitrust laws was left open by the Supreme Court in the Silver case. However this may be, it is clear that antitrust considerations should receive the closest scrutiny.

BACKGROUND

The Commission believes it useful to outline briefly the situation which prompted both the New York Stock Exchange's rate structure proposal and proposed Commission Rule 10b-10 with the expectation that this may contribute to understanding and analysis of these proposals.

In recent years institutional investors, including banks, insurance companies, pension plans and investment companies have accounted for a steadily increasing share of the volume of trading on the exchanges. On the New York Stock Exchange institutional volume as a percent of total public volume has increased from 25.4 percent in March 1956 to 33.8 percent in September 1961, to 39.3 percent in March 1965 and 42.9 percent in October 1966, the latest date available. It should be recognized that these institutional investors usually represent a pooling, under professional management, of savings belonging to a great many individuals, most of whom are small investors. Consequently securities market conditions and practices which affect the investments of these individuals are of wide public interest.

These institutions tend to deal in larger blocks of securities than individual investors ordinarily do. Consequently increasing institutional participation in the exchange markets has been accompanied by a significant increase in the number of large blocks offered and traded. Studies by the New York Stock Exchange show that the number of transactions involving 10,000 shares or more has increased from 2171 in 1965 to 6685 in 1967, that the number of shares involved in these transactions has more than tripled, and that their share of reported volume has increased from 3.1 percent to 6.5 percent.

This situation has thrown an increasing strain on the rigid minimum commission rate structure, adopted many years ago by the New York Stock Exchange and followed by all other national securities exchanges, which is based upon a single round lot, usually 100 shares. There is no volume discount based either on the size of the individual order or upon the amount of portfolio business done by an institutional order or upon the amount of portfolio business done by an institutional investor over a period of time. Thus the commission which a member firm is required by Exchange rules to charge its customer on a 10,000 share transaction is 100 times the commission it is required to charge on a 100 share transaction and the commission on 100,000 shares is 1000 times the commission on 100 shares. Ostensibly all persons who are not Exchange members must pay the minimum commission. There is no distinction among different kinds of nonmember, e.g., nonmember brokers, individual customers, institutional investors, etc.

While orders to buy or sell large blocks involve greater demands on a broker than the execution of a single round lot order, it does not cost a broker anywhere near 100 times as much to execute a 10,000 share order than to execute a 100 share order. Indeed, for certain aspects of the execution process, such as bookkeeping, the cost is essentially the same. As is true in other areas of the business world, broker-dealers engaged in effecting such transactions have enjoyed the great advantages of scale accruing from large transactions. These institutional transactions generally do not involve the payment of a commission to a salesman of the broker, although an institutional brokerage business usually does entail the expense of maintaining an

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1/ Silver v. New York Stock Exchange, 373 U.S. 341 (1963). See also Kaplan v. Lehman Bros., et al., 250 F. Supp. 562 (N.D. Ill., 1966), aff'd 371 F. 2d 409 (C.A. 7, 1967), certiorari denied, ___ U.S. ___, the Chief Justice dissenting, (1967).

institutional trading department and the development of special talents. Consequently, the executing brokers are willing to accept substantially less compensation for executing institutional orders, particularly large institutional orders, than is contemplated by mechanical application of the existing minimum commission rate rules of the exchanges.

Managers of institutional investors have taken advantage of the competition among brokers for institutional business, and the willingness of such brokers to accept compensation far lower than that contemplated by the Exchange rules, to divert or recapture portions of the commission paid on institutional orders. An increasingly complex pattern of practices having this objective has developed. Many of these practices involve the so-called "give-up."

A "give-up" is a payment by the executing broker to other broker-dealers of a part of the minimum commission he is required to charge his customers. Under the rules of the stock exchanges, the payment may be made on the executing broker's own initiative and for his own purposes or it may be directed by the customer. The recipient of a "give-up" check may have had nothing whatsoever to do with the transaction for which the commission is charged and in fact may not even know of the transaction or where or when it was executed. Thus "give-ups" have been widely used in connection with mutual fund portfolio transactions. Managers of mutual funds direct give-ups, for the most part to broker-dealers who have sold fund shares in order to motivate, or reward, such sales effort. On certain orders, the executing broker may retain as little as 25 percent of the commission paid by the fund and give up the balance. Brokers who sell fund shares are thus compensated for their efforts not only by receipt of the dealer's portion of the "sales load" but also by substantial amounts of give-up dollars generated at the direction of the manager of the fund through purchases and sales of fund portfolio securities. Fund managers also often use give-ups as a reward for research ideas furnished to them in their capacity as investment advisers to the funds.

While the New York Stock Exchange permits its members to give up commissions only to other members of that Exchange, the smaller regional exchanges have, with increasing success, competed with the New York Stock Exchange for institutional business, particularly the business of mutual funds, by permitting give-ups of commissions not only to members of the particular exchange but also to any member of the National Association of Securities Dealers, Inc. or even to any registered broker-dealer. By requiring that an order be taken to a regional exchange, a mutual fund manager is able to provide monetary reward to broker-dealers who sell shares of the mutual fund but who are not members of the New York or of any exchange.

Give-ups are widely used in connection with so-called "cross" transactions. These involve situations where the order cannot be adequately executed in the auction process on the floor of an exchange and therefore the institutional broker finds the other side of the trade on the floor, i.e., locates a seller if he has an order to buy or a buyer if he has an order to sell, and then merely records or "crosses" the order on the floor. Exchange rules do not allow member brokers to consummate crosses in their offices or in the over-the-counter market at a negotiated commission, but they do allow the broker to send the transaction to any exchange of which he is a member and to give up from the commissions he must charge on the cross in accordance with the rules of that exchange. By this means large institutional orders can, nominally at least, be executed on small regional exchanges, but where this occurs the usual motive is simply to take advantage of the rules of that exchange with respect to the classes of persons who may receive give-ups.

In addition to the give-up, there have developed complex practices by which executing brokers provide compensation at the direction of institutional investors to other brokers by means of reciprocal business, i.e., permitting such other brokers to participate in the commission generated from execution, in the over-the-counter market or on regional exchanges, of orders which the institutional broker has received from other customers. More recently, certain member firms of the New York Stock Exchange have developed a procedure whereby they can compensate nonmembers of the New York Stock Exchange at the direction of mutual fund managers by paying cash to such nonmembers and crediting such payments on over-the-counter trades for unrelated customers, whether or not commissions were in fact charged on such trades. The compensated dealers have no participation in these trades and, in fact, may never have heard of the trades at the time when they were executed.

Give-ups and reciprocal business practices in connection with institutional trading have become so widespread that it may plausibly be argued that, in the case of large institutional orders, there is in economic substance no fixed minimum commission. Commissions are negotiated between institutional managers and their "lead" brokers with the lead broker on occasion retaining no more than 25 percent of the ostensible minimum commission. This situation is perhaps most strikingly illustrated by procedures which have been developed and which enable institutional investors to recapture a portion of commissions for themselves. Many mutual fund managers have affiliates which are registered as broker-dealers; many of these affiliates are members of the NASD. A small number of mutual fund managers have created affiliates which have joined a regional stock exchange. In the latter situations, the manager directs that give-ups and reciprocal business be given by its lead brokers to its affiliates. It then credits the net income thus received by the affiliate, in whole or in part, against the advisory fee it receives from the fund. This results in lowering the advisory fee by all or part of the net income the manager has thus obtained. Through this means, public shareholders of institutions can, within the framework of existing practices developed by the securities industry, recoup substantial amounts of commissions actually paid for the execution of their portfolio orders despite a rigid commission structure which does not otherwise permit the institution to benefit from the very substantial portfolio business it may have to dispense. In one instance the advisory fees charged to a large complex of mutual funds by their common manager were lowered in the aggregate by approximately $3.1 million for the year 1966, this sum being the approximate net profit of the manager's broker-dealer affiliate. Other managers have elected to credit the advisory fees they charge by only 50 percent of the net profits of their broker-dealer affiliates. In a few instances, the mutual fund manager has kept all give-ups it has directed to its brokerage affiliate for itself without lowering the advisory fees it charges to the fund whose portfolio transactions are the source of such give-ups.

Although these techniques permit fiduciaries who manage a pooled fund to return a portion of portfolio commissions to the shareholders of that fund, they have to date been employed mainly by the managers of those mutual funds whose shares are sold by the manager's own "captive" sales force. Managers of those mutual funds which are distributed by independent broker-dealers have almost always used the excess brokerage to provide additional reward to dealers who sell shares of the fund rather than endeavoring to recapture such brokerage for the fund. This is because by so compensating dealers these mutual fund managers facilitate the sale of shares and thus maximize their own underwriting and investment advisory income. Many mutual fund managers believe that so long as this type of sales incentive can be given to dealers, competition among mutual fund managers for the favor of dealers will make it difficult, if not impossible, for any individual fund manager to fail to provide such compensation to dealers, both members and nonmembers of exchanges, selling shares of his funds. In this connection the Commission has been informed that certain large member firms of the New York Stock Exchange, who maintain extensive mutual fund departments and are a significant factor in the sale of mutual fund shares through dealers, have suggested to mutual fund managers that brokerage be channeled to them if they are to continue to sell shares of the manager's funds.

The net effect of the foregoing developments have been (1) a dramatic increase in the volume of transactions on regional exchanges, 2/ (2) a "diversion" of commissions which otherwise might have been retained by New York Stock Exchange members to

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2/ In 1961 the total dollar volume of transactions on regional exchanges was $4.4 billion; in 1966 it was $10.3 billion. This represented 6.8 percent of the dollar volume of transactions on all exchanges in 1961 and 8.4 percent of such volume in 1966. By comparison New York Stock Exchange dollar volume increased from $5?.7 billion in 1961 to $98.6 billion in 1966; and New York Stock Exchange transactions declined from 82.6 percent of total dollar volume of exchange transactions in 1961 to 80.1 percent of such transactions in 1966. Dollar volume on the American Stock Exchange accounts for the balance. Substantially all of the regional exchange volume consists of trading in securities also traded on the New York Stock Exchange.

(a) other members who perform no function in connection with transactions and (b) nonmembers of the New York Stock Exchange who perform no function on transactions effected by New York Stock Exchange members on regional exchanges, and (3) a developing trend whereby excess commissions—the amounts which, at the direction of institutional managers, executing brokers are willing to give up to persons who perform no service or function in connection with the execution of portfolio transactions—are returned, at least partially, to the institutional customers thereby indirectly benefiting the millions of investors who invest through pooled media such as mutual funds. In short, competition in the securities industry between institutional managers and brokers and between exchanges, has operated to reduce very substantially the amount of commissions actually <u>retained</u> by executing brokers—but with relatively little impact or effect as yet on the commissions actually <u>paid</u> by the public investors who invest through institutional media.

In addition to practices with respect to commissions on institutional transactions, there are certain related competitive phenomena which deserve mention. As previously noted, the New York Stock Exchange rate structure expressly provides that nonmembers of that Exchange—including broker-dealers who are members of a regional exchange—must pay a New York Stock Exchange member a full commission for transactions executed on the New York Stock Exchange. Nevertheless, reciprocal business practices have developed which now give such regional exchange members indirect economic access to the floor of that Exchange.

For example, when a broker-dealer cannot execute its customer's order on the regional exchange of which it is a member, it has the order executed on the New York Stock Exchange, pays a New York Stock Exchange member a full New York Stock Exchange commission and collects that amount from the customer. Thus, the sole member of the regional exchange receives no direct compensation for its customer's order. However, it can receive indirect compensation equal to 50 percent of the commission paid by the customer. The member of the New York Stock Exchange through whom the order was executed brings its own customers' orders to the regional exchange, executes them there and names the sole member broker-dealer as the "clearing agent." Typically, under the rules of regional exchanges, the sole member may receive up to 50 percent of the stock exchange commission for acting as "clearing agent" on such orders, although he performs no function except the largely unnecessary one of guaranteeing performance by the New York Stock Exchange member.

Recent years have also seen a substantial growth in the so-called third market. This involves securities firms which are not members of any exchange and which deal in listed securities over-the-counter, both as principal and as agent, largely for institutional customers and broker-dealers not members of an exchange. Since exchange minimum commission rates do not apply to them, they have been able to execute orders either as principal or as agent for compensation substantially less than that provided for in the minimum commission rate rules. On the other hand, their ability to compete for institutional business has been adversely influenced by the fact that they are not in a position to provide give-ups for the benefit of institutional managers, since give-ups have generally been regarded as proper only where a minimum commission rate is applicable. Two incidents illustrate this point. One firm at one time specialized in executing institutional orders for listed securities in the over-the-counter market at a negotiated commission lower than that provided by exchange rules. Certain mutual fund managers suggested that it join a regional exchange and thus charge the higher commissions specified by the exchange and, at the same time, place itself in a position to distribute give-ups at the request of these managers and it did so in order to retain their business. Another large over-the-counter firm advised the Commission that instead of negotiating its compensation on each large institutional trade, it proposed unilaterally to establish a fixed non-negotiable commission but to give up a portion of this commission at the direction of mutual fund managers. This arrangement, which has not yet been put into effect, was motivated not because the firm thought that its existing negotiated compensation was inadequate but, rather, because it believed that its ability to provide give-ups would substantially improve its competitive position in seeking business from mutual fund managers even though its regular charges imposed on the funds were already lower than the New York Stock Exchange fixed minimum commission.

The Commission's jurisdiction under Section 19(b) of the Securities Exchange Act over Exchange rules with respect to "the fixing of reasonable rates of commission" obviously extends both to the commission rate level and to the commission rate structure. Particularly in the earlier years the Commission's attention appeared to focus primarily on questions of level, although questions of structure also arose. The history of this consideration since 1937 is outlined in considerable detail in the Report of the Special Study of Securities Markets. 3/ As there pointed out, determination of a reasonable level of minimum rates for an industry as diverse, complex and, in a sense, competitive as the New York Stock Exchange brokerage community presents perplexing problems. In addition, questions of structure and questions of level are intimately related. Thus the Exchange proposal for a volume discount pertains to rate level as well as structure and is a response to the fact that the existing level of rates for large institutional transactions has, as a result of competitive factors, fostered the proliferation of give-ups and reciprocal practices.

These practices and problems, as outlined above, some of which are of relatively recent origin, have been the subject of intensive consideration by the Commission over a period of years. Reciprocal business practices and customer directed give-ups were described in the Report of the Special Study of Securities Markets. 4/ It was suggested that they be studied in connection with an intensive inquiry into all aspects of the commission rate structure. They were further discussed in the Commission's 1966 Report on the Public Policy Implications of Investment Company Growth. 5/ Approximately 19 months ago the Commission advised the exchanges of its belief that Exchange rules should be changed to preclude customer directed give-ups. 6/

Since consideration of the New York Stock Exchange proposal necessarily would involve an understanding and consideration of possible alternatives, the Commission believes that proposed Rule 10b-10 should now be noticed for comment. The Commission would thus be in the best position to consider all alternatives, including any which may be suggested.

THE EXCHANGE PROPOSAL

The first item of the New York Stock Exchange proposal involves the establishment of a volume discount. The Exchange has not yet determined the amount of such discount or the circumstances under which it would be available. There are a number of possible alternatives, including (1) a discount based upon the size of a particular order and (2) a discount based upon the volume of a particular investor's transactions over a specified period of time. The Commission assumes that the discount ultimately arrived at would be meaningful and workable. Upon that assumption it would appear that this part of the Exchange proposal would make an important contribution to resolving the problems discussed above and be in accord with suggestions that the Commission has made to the exchanges on several occasions.

Several other parts of the Exchange proposal appear to be based on the view that (1) the relatively untrammeled development of reciprocal and give-up practices, (2) the competitive advantages which regional exchanges have sought in competing for institutional business by increased liberality with respect to give-ups, and (3) the resulting "leakage" of commissions outside the New York Stock Exchange community, as threatening impairment of the depth and liquidity of the New York Stock Exchange market as well as the profitability and financial stability of member firms.

The Exchange proposal seeks to relieve this situation by (1) limiting to the

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3/ Special Study, Pt. 2, 328-346. H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

4/ Special Study, supra, 301, 318.

5/ Mutual Fund Report, Chapter 4, pp. 162-188.

6/ Mutual Fund Report, Chapter 4, pp. 185-186.

extent possible the major types of reciprocal business, (2) specifying the maximum percentages of the commission dollar which may be given away in any manner or, alternatively, specifying the minimum amount which must be retained, (3) preventing the regional exchanges from offering different and more liberal give-up arrangements so that institutional or other investors will not seek to execute or cross their transactions on regional exchanges in order to obtain more favorable give-ups, and (4) preventing what is some times referred to as "institutional membership" on exchanges, which appears to include membership of affiliates of an institutional investor whose function is to receive give-ups and reciprocal business and in whole or in part to pass the income therefrom back to the institutional investor itself. This is a significant part of the New York Stock Exchange proposal which would have a particularly important effect upon the securities markets, and would require action by the Commission. Consequently, comment with respect to it would be appreciated. These aspects of the Exchange's proposal may be viewed together as designed to make its minimum commission rates effective and enforceable insofar as large institutional transactions are concerned.

It would appear that the New York Stock Exchange proposal could have a substantial impact on the regional exchanges. A primary method by which regional exchanges have competed for the portfolio business of institutions has been to offer institutional managers a more flexible rate structure than that of the New York Stock Exchange, i.e., by permitting give-ups to a wider category of persons. Regional exchanges rely heavily on reciprocal business patterns which permit their sole members (nonmembers of the New York Stock Exchange) to obtain indirect access to the New York Stock Exchange. In this connection regional exchange rules facilitate reciprocal business practices by which dual members (members of the New York Stock Exchange and a regional exchange) compensate members of regional exchanges for business executed on the New York Stock Exchange. The New York Stock Exchange proposal would curtail such practices. It also would prevent institutions from obtaining membership on regional exchanges or otherwise engaging in reciprocal business practices which, in effect, reduce the portfolio commissions such institutions pay. Both the impact and the significance of the Exchange proposal, insofar as it involves the regional exchanges, are affected by a change which has taken place in the primary function of the regional exchanges. These exchanges were originally conceived of as primarily providing local markets for local securities. With the passage of time, the emphasis on most of the regional exchanges has shifted to providing a local market for securities traded on the New York Stock Exchange. Technical improvements in communication and the development of over-the-counter markets for local securities have contributed importantly to this change in the nature of the regional exchanges. As pointed out above, in many instances the participation of certain regional exchanges amounts to no more than providing a location where privately negotiated "cross" transactions in New York Stock Exchange listed stocks are recorded and give-ups are distributed.

Finally, the New York Stock Exchange proposal permits the continuation of customer directed give-ups and would expand them to provide for give-ups to nonmember broker-dealers of the New York Stock Exchange on executions on that Exchange. It would also provide for minimum retentions by executing brokers. The justification for these restrictions presumably is that competition in liberality with respect to customer directed give-ups is not a desirable form of competition and that the economic health of the exchange community calls for a sharp and enforceable distinction between public customers and the brokerage industry.

Certain aspects of the New York Stock Exchange proposal are not specific, i.e., the amount, kind, or applicability of the volume discount, the percentage of the minimum commission which a nonmember could receive and the qualifications which nonmembers would have to have in order to become eligible for this "access" and the amount of customer directed give-ups available to members and nonmembers, etc. Further, the Exchange proposal does not indicate whether the Exchange contemplates revision of the commission rate rules to relate commissions more directly to the money involved in a transaction rather than to the number of shares, thus modifying the existing disparity in commissions paid for a given investment in low priced stocks and in high priced stocks. This matter was discussed in a report to the exchange community from Mr. G. Keith Funston, then president of the Exchange, on July 21, 1967. Revisions along this line, as suggested by Mr. Funston, would not only modify this disparity but might provide a convenient way of introducing the proposed volume discount.

The Exchange apparently is initially concerned with the principles and objectives underlying its proposal. In this connection, the Commission assumes that if these principles and objectives are accepted, the Exchange will determine the specifics, i.e., the dollar amounts, the percentages and the definitions, in such a way that the proposal will accomplish its intended purpose. Thus, for example, nonmembers would be offered a sufficient participation in commissions to induce them to bring their orders to the Exchange. The Commission understands that New York Stock Exchange members would be required to retain approximately 50 percent of the commission on any order with the balance available for customer directed give-ups.

The Commission believes that it is possible and appropriate for interested persons to express their views on the principles underlying the Exchange's proposal and the means by which its objectives may be accomplished even though, in the absence of more specific proposals, it may not be possible to determine the specific financial impact of various parts of the proposal on the earnings of various members and nonmembers or on the amount of commissions which institutional investors would pay.

PROPOSED COMMISSION RULE 10b-10

Proposed Rule 10b-10 represents an approach to the give-up problem which would not require significant change in the existing commission rate structure of exchanges nor require all exchanges to adopt a uniform approach to the question of give-ups and reciprocal business.

The Commission recognizes that the proposed rule is not a substitute for full reexamination of the structure and rates of commissions on the national securities exchanges. The proposed rule was under consideration prior to the announcement of the New York Stock Exchange proposal and has its antecedents in the Commission's Report on Investment Company Growth, which stated at p. 173:

> "It would not be inconsistent with [the] rules [of certain regional stock exchanges] for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the fund. 82/
>
> ---
>
> "82/ Alternatively, the fund itself could form a broker-dealer affiliate to which it could direct give-ups. If this course were followed—and no fund now does so—the give-ups would inure to the direct benefit of the fund's shareholders."

The reasoning on which the proposed rule is based is that if, as pointed out above, a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so. Furthermore, diversion of such commissions to benefit an investment company manager may be viewed as additional compensation to the manager for handling the portfolio transactions of the fund within the meaning of, and in violation of, Section 17(e)(1) of the Investment Company Act. 7/

The proposed rule therefore reflects a duty on the part of mutual fund managers as fiduciaries not to use commissions paid by their beneficiaries for the benefit of the

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7/ The Commission does not believe that investment company directors may properly view the benefits derived by fund managers from give-ups as simply an additional form of compensation for investment management. Not only may this run afoul of Section 17(e)(1) of the Investment Company Act but the benefits derived by investment company managers from this source cannot be precisely or adequately disclosed in the prospectus, or in the investment advisory contract, as is required by Section 15(a)(1) of the Investment Company Act.

fiduciary when practices, procedures, and rules of the markets in which such fiduciaries act permit their beneficiaries to receive tangible benefits in the form of reduction of the charges now borne by them. The proposed rule is bottomed on the premise that when a fiduciary uses commissions to obtain benefits for himself under these circumstances, his conduct would appear to violate applicable antifraud provisions of the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 as well as Section 17(e) of the Investment Company Act, particularly in view of the obscure and often devious ways in which this is accomplished. The proposed rule would be adopted pursuant to Sections 10(b) and 15(c)(1) and (2) of the Securities Exchange Act of 1934, Sections 206(4) and 211(a) of the Investment Advisers Act of 1940 and Sections 17(e) and 38(a) of the Investment Company Act.

The proposed rule would not impair the competition which now exists among brokers and among exchanges for the business of institutional customers by offering these customers substantial savings on commissions. On the contrary, the proposed rule recognizes that, as mentioned above, developments and competitive forces in the securities markets have, as an economic matter, tended to eliminate the existence of a fixed minimum commission rate on institutional orders.

The proposed rule would read as follows:

"Rule 10b-10

"(1) It shall be unlawful for any registered investment company or affiliated person of such registered investment company* to directly or indirectly, to order or request any broker or dealer:

"(a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person unless pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to the remittance;

"(b) to designate or employ any broker or dealer on any transaction to transmit, execute or clear a transaction or to perform any other function for which compensation is required or made unless pursuant to a written contract the full amount of such compensation is required to be paid over to such registered investment company or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to such compensation.

"(2) For the purposes of this rule a person is affiliated with a registered investment company if such person:

"(a) is an officer, director, trustee, employee, investment

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* Although the proposed rule is couched only in terms of persons who are affiliates of and fiduciaries to investment companies, the principles which are set forth above may be equally applicable to other managers of pooled funds who act in a fiduciary capacity and who are able to reduce the portfolio commissions of their beneficiaries. To the extent that such managers direct give-ups for their benefit, when they are in a position to utilize them for the benefit of beneficiaries, it would appear that under the Federal Securities Laws or otherwise, this use of give-ups other than for the benefit of these beneficiaries would also constitute an improper practice by such fiduciaries. Accordingly, the Commission believes that it is appropriate to solicit comment on this issue and will consider whether the proposed Rule 10b-10 should be applicable to other fiduciaries who manage pooled funds.

adviser, member of an advisory board, depositor, promoter of or principal underwriter for the registered investment company, or

"(b) directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with the registered investment company, its investment adviser or principal underwriter, or

"(c) directly or indirectly owns, controls, or holds with the power to vote, five per centum or more of the outstanding voting securities of the registered company."

While the New York Stock Exchange proposal and proposed Rule 10b-10 are not mutually exclusive on all points, the New York Stock Exchange proposal is, to a significant extent, an alternative approach. Insofar as the New York Stock Exchange proposal would provide institutional investors with a volume discount while at the same time closing, insofar as possible, the various avenues by which an institutional manager can recoup commissions for the benefit of the fund, it could, depending upon the nature and extent of the volume discount, provide a direct rather than an indirect means by which institutional investors may obtain the benefit of lower charges. To the extent that it would make impossible indirect recoupment of commissions by institutional managers, the question of a fiduciary duty on their part to seek such recoupment would not arise.

All interested persons are invited to submit their views and comments on proposed Rule 10b-10 in writing to the Secretary, Securities and Exchange Commission, at its principal office, 500 North Capitol Street, Washington, D.C. 20549, on or before March 1, 1968. The Commission also invites comments on the New York Stock Exchange proposal which is set forth in the attachment of this release, as well as any alternative suggestions for dealing with the problems presented. Material submitted will be made available for public inspection unless request for confidential treatment is made.

By the Commission.

Orval L. DuBois
Secretary

Attachment

IN REPLYING PLEASE QUOTE

NY-Q(LEJ)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
REGIONAL OFFICE
26 FEDERAL PLAZA
NEW YORK, N.Y. 10007

February 9, 1970

Mr. George M. Charles
The University of Oklahoma
College of Business Administration
Department of Finance
Norman, Oklahoma 73069

Dear Mr. Charles:

We are in receipt of your recent letter in which you pose a list of broad and searching questions concerning the abolition of customer directed give ups. As you can appreciate, this office cannot perform the functions that your research studies impose upon you. However, it is suggested that you investigate the following sources which should be helpful in your search for information:

(1) Federal Securities Law Reporter - Commerce Clearing House Publication;

(2) "Securities Regulation," Louis Loss (6 volume treatise);

(3) "Report of SEC Special Study of Securities Markets (1963)," available for reference only at the Securities & Exchange Commission;

(4) "Report of the SEC on the Public Policy Implications of Investment Company Growth - only available for reference purposes at Securities & Exchange Commission.

Not more than a year ago, the Institutional Investor Study was established, and although no publications have been issued by them, you might wish to contact their office at the Securities and Exchange Commission, Washington, D.C. for any information they might be authorized to render. In addition, you should contact the various exchanges referred to in your letter for materials they could make available to you regarding your topic.

Enclosed are some releases dealing with commission give-ups and the Classification of Releases and the Government Printing Office price list from which you may order whatever statistical or other materials in which you might be interested.

In the future you may find it more convenient to communicate with the Fort Worth Regional Office which services your area of the country. They are located at:

U. S. Courthouse
10th & Lamar Streets
Fort Worth, Texas 76102

I trust this will be of some assistance to you.

Sincerely yours,

RICHARD V. BANDLER
Branch of Legal Interpretations

By

Lawrence E. Jaffe, Attorney
Branch of Legal Interpretations

Encls.
GPO price list
Classif. of Rel. & card
Releases 8239, 8746 and 8791

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
POLICY RESEARCH

May 27, 1970

Mr. George Charles
College of Business Administration
Department of Finance
University of Oklahoma
Norman, Oklahoma 73069

Dear Mr. Charles:

Enclosed please find a broker-dealer computer list which includes those broker-dealers who checked on their registration that more than 10 percent of their revenue is from mutual fund sales. Because of the difference in the time of registration of these firms, you may want to include a query in your questionnaire as to the present importance of mutual fund sales. As you will note, the list is by state and has attached a code sheet with the broker-dealer registration form for reference.

Sincerely yours,

Gene L. Finn
Chief Economist

Enclosures

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 9, 1970

Mr. George Charles
Department of Finance
College of Business Administration
Norman, Oklahoma

Dear Mr. Charles:

Enclosed is the material that we have discussed in our telephone conversation:
"Application for Registration as a Broker-Dealer or to Amend such an Application Under the Securities Exchange Act of 1934", and "Analysis of the Population of SEC Registered Broker/Dealers who Concentrate in Mutual Fund Share Sales".

Sincerely yours,

Gene Finn

Gene L. Finn
Chief Economist

Enclosure

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
POLICY RESEARCH

September 11, 1970

Mr. George M. Charles
University of Manitoba
Department of Accounting and Finance
School of Commerce
Winnepeg, Manitoba. Canada

Dear George:

I appreciate very much your keeping us posted on the progress of your thesis. We, of course, are very much interested in obtaining a copy as soon as you can make it available.

With regard to the computer printouts that we furnished you earlier, you can keep them if you desire. We are not likely to have need of them in the future and if by any chance we do, we would probably want updated lists anyway.

Personally, I am very pleased that we were able to be of assistance in your research. It is always a pleasure to be associated with someone, such as yourself, who is completing his PhD. requirements.

Sincerely yours,

Gene

Gene L. Finn
Chief Economist

CODE SHEET FOR COMPUTER LIST

1. Coded G in the first "Item" column indicates that the applicant or registrant is holding itself out as a firm whose principal type of business is a mutual fund retailer.

   Coded in "Item" column 23 (b)

   Coded "N" in this last column indicates that the applicant or registrant does not engage in any other nonsecurities business.

   Coded "Y" in this last column indicates that the applicant or registrant engages in other nonsecurities business.

2. Legal form of business, coded in SPCO column:

   Coded C indicates a corporation
   Coded S indicates a sole proprietorship
   Coded P indicates a partnership
   Coded O indicates some other type of business

3. Coded 1 in none column indicates applicant or registrant is not a member of any national securities exchange.

   Coded O in none column indicates that the applicant or registrant is a regular or associated member firm of one or more of the following national securities exchanges:

   American
   Boston
   Chicago Board of Trade
   Cincinnati
   Detroit
   Midwest
   National
   New York
   Pacific Coast
   Phila.-Balt.-Wash.
   Pittsburgh
   Salt Lake
   Spokane

FORM BD (Instruction Sheet) | APPLICATION FOR REGISTRATION AS A BROKER-DEALER OR TO AMEND SUCH AN APPLICATION UNDER THE SECURITIES EXCHANGE ACT OF 1934

SECURITIES AND EXCHANGE COMMISSION • WASHINGTON, D.C. 20549

GENERAL INSTRUCTIONS FOR PREPARING AND FILING FORM BD

1. This Form and any Schedule and continuation sheets required in connection with it shall be completed and filed in *triplicate* with the Securities and Exchange Commission, Washington, D.C. 20549. Retain one exact copy for your records. All information required by Form BD and any Schedule thereunder must be submitted on the officially prescribed forms, additional copies of which are available, upon request, at any office of the Commission.

2. If the space provided for any answer on the Form is insufficient, the complete answer shall be prepared on Schedule E, which shall be attached to the Form. If the space provided for any answer on the Schedules is insufficient, the answer shall be completed on additional copies of the applicable Schedule which shall also be attached to the Form.

3. Individuals' names, except the executing signature in Item 9, shall be given in full wherever required (last name, first name, middle name).

4. All three copies of this Form filed with the Commission shall be executed with a *manual signature* in Item 9. If the Form is filed by a sole proprietor, it shall be signed by the proprietor; if it is filed by a partnership, it should be signed in the name of the partnership by a general partner; if filed by an unincorporated organization or association which is not a partnership, it shall be signed in the name of such organization or association by the managing agent—i.e., a duly authorized person who directs or manages or who participates in the directing or managing of its affairs; if filed by a corporation, it shall be signed in the name of the corporation by a principal officer duly authorized.

5. A Form which is not prepared and executed in compliance with applicable requirements may be returned as not acceptable for filing. However, acceptance of this Form shall not constitute any finding that it has been filed as required or that the information submitted is true, current or complete.

SPECIAL INSTRUCTIONS FOR FILING FORM BD AS AN APPLICATION

6. If Form BD is being filed as an application for registration, all applicable items must be answered in full. If any item is not applicable, indicate by "none" or "N/A" as appropriate.

7. If the Form is filed as an application by a predecessor broker-dealer on behalf of a successor not yet formed or organized, the information furnished shall relate to the successor to be formed. The Form shall be executed by the predecessor. Section 15(b) of the Securities Exchange Act of 1934 and Rule 15b2-1 provide that registration shall terminate on the forty-fifth day after the effective date unless prior thereto the successor shall adopt the application as its own. *This procedure cannot be used where the successor is a sole proprietor.*

8. Rule 15b1-2 requires a statement of financial condition to be filed *in duplicate* with every application for registration. Consult Rules 15b1-5 and 17a-7 to determine whether any nonresident of the United States named in the Form is required to file a consent and power of attorney, or a notice or undertaking with respect to books and records.

SPECIAL INSTRUCTIONS FOR AMENDING FORM BD

9. Rule 15b3-1 requires that if the information contained in the application, or in any supplement or amendment thereto, is or becomes inaccurate for any reason, an amendment must be filed promptly on Form BD correcting such information.

10. A completed page 1, including the Execution, must be filed with each amendment. Otherwise only the pages being amended need be filed.

CAUTION: WHEN ANY ITEM ON A PAGE IS AMENDED, IT IS NECESSARY TO ANSWER ALL ITEMS ON THE PAGE BEING AMENDED. PAGES WHICH CONTAIN OBSOLETE INFORMATION ARE RETIRED TO THE COMMISSION'S INACTIVE FILES.

DEFINITIONS: Unless the context clearly indicates otherwise, all terms used in the Form have the same meaning as in the Securities Exchange Act of 1934 and in the General Rules and Regulations of the Commission thereunder.

FORM BD

(Revised: 9-1-68)
Page 1.

APPLICATION FOR REGISTRATION AS A BROKER-DEALER OR TO AMEND SUCH AN APPLICATION UNDER THE SECURITIES EXCHANGE ACT OF 1934

SECURITIES AND EXCHANGE COMMISSION • WASHINGTON, D.C. 20549

SEC USE
FILE NO. 8–
DOC. SEQ. NO.

(Read instruction sheet before preparing Form. Please print or type)

1. (a) If this is an APPLICATION for registration, *check here,* ☐ and complete all items in full.
   (b) If this is an AMENDMENT to an Application, *check here,* ☐ and specify below all parts which are amended.
   Item(s) ______________ of Page 1 of Form BD Schedule A________ Schedule B________
   Item(s) ______________ of Page 2 of Form BD
   Item(s) ______________ of Page 3 of Form BD Schedule C________ Schedule D________ Schedule E________

2. Full name of Applicant or Registrant: (If individual, state last, first, middle name) *IRS Empl. Ident. No.*

3. Name under which business is conducted, if different:

4. If name of business is hereby amended, state previous name here:

5. Address of principal place of business: (Do not use P.O. Box Number)

No. and Street	*City*	*State*	*ZIP Code*

6. Mailing Address, if different:

7. Is Applicant taking over all or substantially all of the assets and liabilities and continuing the business of a registered broker-dealer? Yes ☐ No ☐

   If "yes" state:
   (a) Date of succession: ______________
   (b) Date of the last Form X-17A-5 report pursuant to Rule 17a-5 under the Securities Exchange Act filed by the predecessor: ______________
   (c) Full name and IRS Emp. Ident. No. of predecessor: ______________

8. Applicant or Registrant consents that the notice of any proceeding before the Commission in connection with its application for or registration as a broker-dealer may be given by sending notice by registered or certified mail or confirmed telegram to the person named below, at the address given.

(Last name) *(First name)* *(Middle name)*

(Number and street)

(City) *(State)* *(ZIP Code)*

9. EXECUTION: The Applicant or Registrant submitting this Form and its attachments and the person by whom it is executed represent hereby that all information contained therein is true, current and complete. It is understood that all required items and Schedules are considered integral parts of this form and that the submission of any amendment represents that all unamended items and Schedules remain true, current and complete as previously submitted.

Dated the ________ day of ______________ 19____

(Name of Corporation, Partnership or other organization)

(Manual signature of Sole Proprietor, General Partner, Managing Agent or Principal Officer)

(Title)

ATTENTION—Intentional misstatements or omissions of facts constitute Federal Criminal Violations. (See 18 U.S.C. 1001 and 15 U.S.C. 78ff (a))

(All items on this page must be answered in full.)

DO NOT WRITE BELOW THIS LINE—FOR SEC USE

FORM BD, page 2

SEC USE	
FILE NO. 8–	DOC. SEQ. NO.

10. Applicant or Registrant is *(Check one box)*

☐ A corporation ☐ A partnership
☐ A sole proprietorship ☐ Other (specify)

11. If Applicant or Registrant is a *sole proprietor*, state full residence address:

____
(Number and Street)

______________ ______________ ______________
(City) *(State)* *(ZIP Code)*

12. If Applicant or Registrant is a *corporation*:

(a) State date and place of incorporation: ______________

____

(b) List below:

(Classes of equity securities)	*(Voting or Non-Voting)*

(c) Complete Schedule A for (1) officers, directors and persons with similar status or functions and (2) any other person who is directly or indirectly the beneficial owner of 1 percent or more of the authorized shares of any class of equity security of applicant or registrant.

13. If Applicant or Registrant is a *partnership*, complete Schedule B.

REMINDER: If a registered partnership is dissolved and a new one is created to continue the business of the old one, the new partnership must file a new application for registration as a broker-dealer.

14. If Applicant or Registrant is *other* than a sole proprietor, partnership, or corporation:

(a) Describe here the type of organization or association:

____

(b) Complete Schedule C.

15. (a) Does any person not named in Items 2 and 12–14, inclusive, or any Schedule thereunder, directly or indirectly, through agreement or otherwise, exercise or have power to exercise a controlling influence over the management or policies of Applicant or Registrant? Yes ☐ No ☐

If "Yes," state on Schedule E the full name (last, first, middle) of each such person and describe the agreement or other basis through which such person exercises a controlling influence.

(b) Is the business of Applicant or Registrant wholly or partially financed, directly or indirectly, by any person not named in Items 12–14, inclusive, or any Schedule thereunder in any manner *other than by:* (1) a public offering of securities made pursuant to the Securities Act of 1933; (2) credit extended *in the ordinary course of business* by suppliers, banks or others; or (3) a satisfactory subordination agreement, as defined in Rule 15c3–1 under the Securities Exchange Act of 1934? Yes ☐ No ☐

If "Yes," state on Schedule E the full name (last, first, middle) of each such person and describe the agreement or arrangement through which such financing is made available, including amount thereof.

16. State whether the Applicant or Registrant, any person named in Items 12, 13, 14, and 15 or any Schedule thereunder, or any other person directly or indirectly controlling or controlled by the Applicant or Registrant, including any employee:

(a) Has been found by the Commission to have made or caused to be made in any application for registration or report required to be filed with the Commission under the Securities Exchange Act of 1934, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false and misleading with respect to any material fact, or to have omitted to state in any such application or report any material fact which was required to be stated therein. Yes ☐ No ☐

(b) Has been convicted, within 10 years of any felony or misdemeanor (1) involving the purchase or sale of any security; (2) arising out of the conduct of the business of a broker, dealer, or investment adviser; (3) involving embezzlement, fraudulent conversion, or misappropriation of funds or securities; or (4) involving violation of Section 1341, 1342 or 1343 of Title 18 United States Code (mail fraud, fraud by wire [including telephone, telegraph, radio or television]). Yes ☐ No ☐

(c) Is permanently or temporarily enjoined by order, judgment, or decree of any court from acting as an investment adviser, underwriter, broker, or dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security. Yes ☐ No ☐

(d) Has been found by the Commission or any court to have violated or to have aided, abetted, counselled, commanded, induced or procured the violation by any other person of the Securities Act of 1933, or the Securities Exchange Act of 1934, or the Investment Advisers Act of 1940, or the Investment Company Act of 1940, or of any rule or regulation under any of such Acts, or to have failed reasonably to supervise another person who committed such a violation. Yes ☐ No ☐

(e) Has been the subject of an order of the Commission entered pursuant to paragraph (7) of Section 15(b) of the Securities Exchange Act of 1934, as amended, barring or suspending the right of such person to be associated with a broker or dealer. Yes ☐ No ☐

(f) Has been denied membership or registration with or suspended, revoked or expelled from membership or registration with the National Association of Securities Dealers, Inc., or any national securities exchange; or has been suspended or barred from being associated with any member of such association or any member of such exchange. Yes ☐ No ☐

(g) Has been found to have been a cause of the denial, suspension, revocation or expulsion of any person's membership or registration with the National Association of Securities Dealers, Inc. Yes ☐ No ☐

(h) Has been denied registration (license) with or suspended, revoked or expelled from registration (license) with any state, territory or the District of Columbia or any agency thereof as a broker, dealer, investment adviser, securities salesman or as a person associated with a person engaged in such business. Yes ☐ No ☐

(i) Has been the subject of any order, judgment, decree or other sanction of any foreign court, foreign exchange, or foreign governmental or regulatory agency arising out of any securities or investment advisory activities? Yes ☐ No ☐

(j) Has been within the past 10 years, the subject of any cease and desist, desist and refrain, prohibition or similar order which was issued by any state, territory or the District of Columbia, arising out of the conduct of the business as a broker-dealer or investment adviser? Yes ☐ No ☐

If this is an amendment and the answer to any paragraph of this item is changed from "Yes" to "No," explain on a separate Schedule E.

If any item on this page is amended, you must answer in full all other items on this page and file with a completed and executed page one. No Schedule required by any item on this page need be filed with an amended item unless the Schedule itself is amended.

U.S. GOVERNMENT PRINTING OFFICE: 19—O-332-953

FORM BD, page 3

SEC USE	
FILE NO.	DOC. SEQ. NO.
8–	

17. Complete a separate Schedule D for each natural person named in Items 2, 12, 13, 14 and 15 or any Schedule thereunder, except that Schedule D need not be furnished for any person who meets both of the following conditions: (1) he owns less than 10 percent of any class of equity security of applicant or registrant and (2) he is not an officer, director or person with similar status or functions. Also, complete a separate Schedule D for each person subject to any action reported under Item 16.

18. Does Applicant or Registrant:

(a) Have any arrangement with any other person, firm or organization under which:

(1) any of the accounts or records of Applicant or Registrant are kept or maintained by such other person, firm or organization? Yes ☐ No ☐

(2) such other person, firm or organization (other than a bank) holds or maintains funds or securities of applicant or registrant or of any of its customers? Yes ☐ No ☐

(b) Have any arrangement with any other broker or dealer under which the Applicant or Registrant refers or introduces customers to such other broker or dealer? Yes ☐ No ☐

If the answer to any paragraph of this item is "Yes," furnish as to each such arrangement the name and address of the other person, firm or organization, and a summary of the arrangement on a Schedule E.

19. Applicant or Registrant:

(a) Has an application pending with or is a member of the National Association of Securities Dealers, Inc. Yes ☐ No ☐

(b) Has withdrawn application for or voluntarily terminated membership in the National Association of Securities Dealers Inc. (Applicants or registrants not members of the National Association of Securities Dealers should note the provisions of Sections 15(b)(8), (9) and (10) of the Securities Exchange Act of 1934 and the rules thereunder). Yes ☐ No ☐

20. Applicant or Registrant is a regular or associated member firm of the following national securities exchange. *(Please Check)*

☐ None	☐ National
☐ American	☐ New York
☐ Boston	☐ Pacific Coast
☐ Chicago Board of Trade	☐ Phila.-Baltimore-Wash.
☐ Cincinnati	☐ Pittsburgh
☐ Detroit	☐ Salt Lake
☐ Midwest	☐ Spokane

21. Does Applicant or Registrant control directly or indirectly any partnership, corporation or any other organization engaged in the securities or investment advisory business? If "Yes," state name and address of such organization and describe the nature of control on Schedule E. Yes ☐ No ☐

22. Check principal types of business engaged in (or to be engaged in, if not yet active) by Applicant or Registrant. Do not check any category which accounts for—or is expected to account for—less than 10 percent of annual gross income.

(a) Exchange member engaged in exchange commission business ....[ ]

(b) Exchange member engaged in floor activities..........[ ]

(c) Broker or dealer making inter-dealer over-the-counter markets in corporate securities....................[ ]

(d) Broker or dealer retailing corporate securities over-the-counter ....[ ]

(e) Underwriter or selling group participant (corporate securities other than mutual funds)...............[ ]

(f) Mutual fund underwriter or sponsor..................[ ]

(g) Mutual fund retailer..............................[ ]

(h) Government or municipal bond dealer.................[ ]

(i) Broker or dealer selling variable annuities.............[ ]

(j) Solicitor of savings and loan accounts.................[ ]

(k) Real estate syndicator and mortgage broker and banker..[ ]

(l) Broker or dealer selling oil and gas interests..........[ ]

(m) Put and call broker or dealer or option writer..........[ ]

(n) Broker or dealer selling securities of only one issuer or associated issuers (Other than mutual funds).........[ ]

(o) Broker or dealer selling securities of non-profit organizations (e.g., churches, hospitals)...................[ ]

(p) Investment advisory services.......................[ ]

(q) Any other securities activity........................[ ]

Specify below:

23. (a) Does Applicant or Registrant effect transactions in commodities as a broker for others or for its own account? Yes ☐ No ☐

(b) Does Applicant or Registrant engage in any other non securities business? If yes, describe briefly on a Schedule E such other business. Yes ☐ No ☐

If any item on this page is amended, you must answer in full all other items on this page and file with a completed and executed page one.

No Schedule required by any item on this page need be filed with an amended item unless the Schedule itself, is amended.

U.S. GOVERNMENT PRINTING OFFICE:1969—O-332-953

APPENDIX II

DETERMINATION OF THE SAMPLE SIZE OF THE QUESTIONNAIRE SURVEY

Determination of the Sample Size for the Questionnaire Survey

The formula for the standard error of a percentage is:

$$\sigma_p = \sqrt{\frac{pq}{N}}$$

Since the sample constitutes an appreciable portion of the population, the formula is modified by $(1 - \frac{N}{P})$.

$$\sigma_p = \sqrt{\frac{pq}{N}\left(1 - \frac{N}{P}\right)}$$

Where p = the percentage of the sample possessing the given attribute

q = the percentage of the sample not possessing the given attribute = 1 - p

N = the size of the sample

P = the size of the population

Let p = .5--this is the most conservative value for p and its highest probable value.

Confidence interval = 99 per cent

Precision = $\pm$ 5%

P = 2800

The value used for σ_p is $2.58\ \sigma_p = .05$

$$\sigma_p = .0194$$

$$\sigma_p = \sqrt{\frac{pq}{N}\left(1 - \frac{N}{P}\right)}$$

$$.0194 = \sqrt{\frac{(.5)(.5)}{N}\left(1 - \frac{N}{2800}\right)}$$

$$.0194 = \sqrt{\frac{.25}{N}\left(\frac{2800 - N}{2800}\right)}$$

$$.0194 = \sqrt{\frac{700 - .25N}{2800N}}$$

$$(.0194)^2 = \frac{700 - .25N}{2800N}$$

$$(2800N)(.00037636) = 700 - .25N$$

$$1.0538N = 700 - .25N$$

$$1.0538 + .25N = 700$$

$$1.3038N = 700$$

$$N = 536.8 \quad \text{or } 537$$

APPENDIX III

COPIES OF QUESTIONNAIRE AND COVERING LETTERS

CONFIDENTIAL SURVEY TO DETERMINE THE EFFECTS OF THE BAN ON CUSTOMER DIRECTED 'GIVE-UPS' ON MEMBERS OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS

1. Exchange Memberships. (Check memberships held during 1968 and 1969.)

	1968	1969		1968	1969
None	( )	( )	P-B-W	( )	( )
New York Stock Exchange	( )	( )	Boston	( )	( )
American Stock Exchange	( )	( )	Detroit	( )	( )
Pacific Coast	( )	( )	Pittsburgh	( )	( )
Midwest	( )	( )	Cincinnati	( )	( )

Other (Indicate Exchange and year of membership.)____________________

2. Gross Income. (Check appropriate space for 1968 and 1969.)

	1968	1969		1968	1969
Under $50,000	( )	( )	500,000 - 1,000,000	( )	( )
50,000 - 100,000	( )	( )	1,000,000 - 1,500,000	( )	( )
100,000 - 200,000	( )	( )	1,500,000 - 2,000,000	( )	( )
200,000 - 300,000	( )	( )	2,000,000 - 2,500,000	( )	( )
300,000 - 500,000	( )	( )	Over $2,500,000	( )	( )

3. Income from Mutual Fund Operations as a Percentage of Total Gross Income. (In determining income figures please take into account give-ups.) (Please check.)

Percent	1968	1969	Percent	1968	1969
0 - 10	( )	( )	50 - 70	( )	( )
10 - 30	( )	( )	70 - 90	( )	( )
30 - 50	( )	( )	90 - 100	( )	( )

4. Because of the ban on give-ups, are you now contemplating a merger you would not have previously contemplated? (Please check.) Yes ( ) No ( )

5.a. Did your company merge in 1969? Yes ( ) No ( )

b. If a merger took place in 1969, approximately how much of an increase in 1969 total gross income was caused by the merger?

Percent			Percent		
0 - 10	( )	( )	50 - 70	( )	( )
10 - 30	( )	( )	70 - 90	( )	( )
30 - 50	( )	( )	90 - 100	( )	( )

6. To what extent has the loss in income from customer directed give-ups been compensated for by income from new reciprocal business? An example of this would be direct orders from mutual funds for execution.

Percent			Percent		
0 - 25	( )	( )	50 - 75	( )	( )
25 - 50	( )	( )	75 - 100	( )	( )

7. Have you any comments on how the ban on give-ups has affected your firm? Has it caused changes such as the introduction of a block trading department, changes in the sales force, etc., in your company that would not normally have taken place? (Please use back of the page if additional comments are necessary.)

____

____

____

8. The principal type of business of my firm is as a retailer of mutual funds. Yes ( ) No ( )

9. If you would be interested in receiving the results of this study, please check one of the following spaces. Yes ( ) No ( )

COLLEGE OF
BUSINESS ADMINISTRATION
DEPARTMENT OF FINANCE

THE UNIVERSITY OF OKLAHOMA
NORMAN, OKLAHOMA, 73069

June 16, 1970

Dear Sir:

I am completing a dissertation to determine (1) how the ban on customer directed give-ups has affected the revenues of brokerage firms dealing in mutual funds; and (2) to ascertain if the ban instituted by the Securities and Exchange Commission has been detrimental to some firms and beneficial to others.

I discussed this project with the National Association of Securities Dealers and the Securities and Exchange Commission in Washington. Both organizations approve of what I am doing. It is possible that the findings of the survey could result in legislative reform beneficial to you as a retailer of mutual funds. In addition, you may wish to know how other firms in the industry have been affected by the ban on give-ups.

I have enclosed a one-page questionnaire; your cooperation in completing and returning it in the stamped addressed envelope will be sincerely appreciated.

The questionnaire is simple and should take you only a few minutes to complete. Since I am not asking you to indicate the name of your firm, the information you give will be strictly confidential. Furthermore, neither the questionnaire nor the return envelope is coded in any way.

I hope you will reply as soon as possible, for I would like to make the results of the survey available while the information is still up to date.

Sincerely,

George M. Charles

George M. Charles

Enclo.

The University of Oklahoma | 307 West Brooks, Room 202 | Norman, Oklahoma 73069

College of Business Administration Department of Finance

June 30, 1970.

Dear sir:

Two weeks ago I mailed you a questionnaire with a covering letter explaining that I was completing a doctoral dissertation to determine (1) how the ban on customer directed give-ups instituted by the S.E.C. had affected the revenues of brokerage firms dealing in mutual funds; and (2) to ascertain if the ban had been detrimental to some firms and beneficial to others.

The response to the questionnaire has been very positive, but naturally, the more replies received, the more affective the study will be. You may already have replied, but I have no way of knowing the names of the respondents. You will recall that in order to keep the replies absolutely confidential I did not request names on the questionnaires; neither were they coded in any way for purposes of identification.

If you have replied, then please disregard this letter. If you have not yet answered, I would really appreciate your taking a few minutes to complete the questionnaire, and returning it immediately in the stamped addressed envelope.

If I am to complete the dissertation in time for summer graduation, all the responses must be in by July 15 for analysis and interpretation. I am convinced that the results of this study will prove extremely beneficial to you and other broker - dealers in the industry. Your reply is eagerly awaited.

Sincerely,

George M. Charles.

George M. Charles.

APPENDIX IV

RELEASES OF THE NEW YORK STOCK EXCHANGE

TO MEMBERS AND ALLIED MEMBERS

NEW YORK STOCK EXCHANGE

ELEVEN WALL STREET

NEW YORK, N.Y. 10005

ROBERT W. HAACK
PRESIDENT

January 2, 1968

TO: Members and Allied Members

SUBJECT: Commission Rate Structure Proposal

A principal unsolved problem facing the securities industry is that involving the New York Stock Exchange commission rate structure. The complexities and ramifications are such that they are not generally understood even though they directly or indirectly affect the New York Stock Exchange and its members, regional exchanges and their members, the third market, non-member broker-dealers, institutional investors and, of course, the public.

The problem has become more acute by reason of certain pressures which are building up in Congress, government agencies and departments, a segment of the press and the SEC which has oversight responsibilities in the area. The issue is further complicated by the fact that the Exchange, enjoying the privilege of self-regulation and operating under a government approved commission rate structure and certain anti-trust immunities, has an obligation to review its fees and industry developments and practices in the light of public interest. This is a problem which cannot be solved by the Exchange alone. However, inaction on our part is apt to result in the problem being solved by those outside the industry who may be less familiar with the ramifications and as a result might direct changes less satisfactory than those we initiate.

The minimum commission rate is ceasing to be a "minimum" because of practices which have developed and which are proliferating. This is the case in large measure because certain institutional investors are naturally desirous of achieving a lower commission rate on large transactions, and brokers who are non-members of this Exchange are understandably interested in achieving access to the commission dollar. To accomplish these objectives, among others, a wide range of devices is being employed. Membership on regional stock exchanges, used in both simple and complex reciprocal arrangements related to NYSE transactions, has resulted in a practical access to the New York Stock Exchange. Other practices have in effect given certain institutions commission discounts. One exchange, by permitting rebates to SECO members, in effect is giving a public and institutional discount. Through complicated arrangements there are now certain sophisticated individuals who manage to receive 40% rebates on their listed transactions. The net result, in brief, is an intricate maze involving give-ups, give-aways, reciprocal practices, manufactured participations in trades, transported trades moved from one Exchange to another, all of which result in a leakage of the commission dollar.

The situation also reflects a commission structure which was most recently revised in 1959 and which does not properly recognize significant changes which have since taken place in the mix of our business. We are all aware of the increased institutional activity which is one of the significant phenomena of our time and which in all likelihood will continue to grow. It seems reasonable that institutional business with its unique characteristics and demands must be recognized in our commission charges. Moreover, failure to recognize and speak to the problem will inevitably result in a diversion of activity to competing marketplaces.

Because of all of the foregoing, the Board of Governors has unanimously adopted a resolution which had earlier been recommended by the Cost and Revenue Committee and which has the further approval of the Regional Firms Advisory Committee and the Liaison Committee of the Association of Stock Exchange Firms to the effect that the New York Stock Exchange proposes to

(1) incorporate a volume discount in the minimum commission schedule, the amount and nature of such discount to be subsequently determined.

(2) support continuation of the practice of customer directed give-ups on their own transactions with a limitation on the percentage amount which may be so given-up.

(3) take steps to prohibit reciprocal practices which result in de facto rebates of NYSE commissions even where those arrangements involve other markets than the NYSE floor, provided that the SEC will aid in prohibiting such practices in other markets.

(4) allow a discount in the minimum commission schedule for non-member brokers, both domestic and foreign, with qualifications to be specifically defined subsequently.

(5) at the order of the SEC to this and other registered exchanges, adopt rules limiting membership and broker-dealer allowances to bona fide broker-dealers.

Because of the interrelationship of these proposals these courses of action are offered as a package. Further, the specific details of each of the five elements of the package will have to be developed subsequently.

The first proposal described would give directly to large investors, principally institutions, and to the public which has entrusted its funds to institutions, a commission reduction to which they are entitled by size of transaction and which some are presently receiving circuitously.

Continuance of customer directed give-ups on a reduced and controlled basis would tend to eliminate abuse in granting of reciprocals, and would give recognition to the fact that there is more to an order than its execution.

The third proposal, involving an enforcement of rebate rules, would help to eliminate undesirable reciprocal practices and arrangements engaged in by some which through certain other exchanges and the over-the-counter market, result in NYSE commission "leakage".

Because we recognize and respect the desire of non-NYSE brokers to merchandise securities listed on our Exchange profitably, and preferring not to have them compensated by artifice, we propose that certain qualified brokers be given an opportunity to share the commission dollar directly instead of indirectly. The public will be better served and depth and liquidity of markets on our Floor will be improved.

Our last proposal restricting future membership in any exchange to bona fide broker-dealers is necessary to insure the health and vitality of our securities distribution and auction market mechanisms as we know them.

Chairman Gustave Levy and I presented these proposals for consideration by the SEC this morning. I cannot emphasize too strongly the important role that the SEC must play in considering and evaluating the action which has been taken by the Board of Governors.

Subject to Commission reaction, the Cost and Revenue Committee intends to proceed immediately with drafting rules and commission structure to accomplish these ends.

Robert W. Haack

Robert W. Haack,
President

NEW YORK STOCK EXCHANGE

ELEVEN WALL STREET

NEW YORK, N.Y. 10005

ROBERT W. HAACK
PRESIDENT

June 27, 1968

TO: Members and Allied Members

SUBJECT: Board Decisions on Volume Discount, Customer-Directed Give-Ups and Nonmember Broker Discount

At its policy meeting today, the Board of Governors decided on three basic elements for a new commission structure. These principles follow -- with one significant exception -- the proposals we put forward last January 2. Today's Board action was taken on the basis of a report from the Costs and Revenues Committee and after consultation with the advisory groups representing the viewpoints of regional firms and of the Association of Stock Exchange Firms.

The principles are being discussed with the Securities and Exchange Commission as the framework for a new commission schedule. A detailed schedule, as well as several alternates, are already being tested for their potential effect on the current mix of the securities business and on member firm revenues. It is hoped that, subject to the discussions with the SEC, the new schedule can be proposed during the summer.

Since the three proposals complement one another, the Board believes that final action with respect to each should be taken simultaneously. The three points are as follows:

(1) The Board of Governors reaffirms its approval of incorporating a volume discount in a new commission schedule. Such a discount would recognize the lower handling costs of block orders as compared to smaller transactions. It would also give directly to large investors, mainly institutions, and to the public that has entrusted its savings to the institutions, a reduction in commissions.

At the same time, the schedule we are working on would mitigate disparities that now exist between commission costs for low-priced and high-priced issues.

(2) Nonmember brokers, both domestic and foreign, who can meet prescribed qualifications would be entitled to a discount of up to one-third from the minimum commission schedule. We favor amendments to Article XV of the Exchange Constitution to allow qualified non-NYSE brokers to have access to our markets and be compensated directly for their efforts. The additional participation in our market should enhance its depth and liquidity.

Before such a change in our Constitution and Rules can be made, the problem posed by Section 3(a)(3) of the Securities Exchange Act of 1934 would have to be resolved. That provision defines a "member" as a person who is permitted to make use of the facilities of the Exchange for transactions thereon "with the payment of a commission or fee which is less than that charged the general public." Because of the obligations the Act places on the Exchange to police and discipline members, it would have to be made clear that non-member firms qualified to receive such a discount would not be regarded as "members." This could be accomplished either by an amendment to the 1934 Act, or by an appropriate rule promulgated by the SEC under the Act.

(3) The Exchange considers that continuation of customer-directed give-ups weakens the economic basis of the minimum commission structure itself. Therefore, the Board has voted in favor of their step-by-step prohibition. For obvious reasons, customer-directed give-ups cannot be effectively abolished by the unilateral action of one national securities exchange. To be effective, the action must apply uniformly to all markets. If not, such give-ups would likely continue on any exchange whose rules permitted them, to the detriment of exchanges where they were not allowed.

At a time when the principle of minimum commissions is being questioned, it may be more difficult to defend the economic basis of the minimum commission law if members are able to give up, or give away, a substantial part of the minimum commission. In any case, a commission schedule that includes a volume discount would reduce the wherewithal for give-ups.

We are asking the SEC to take appropriate action to initiate step-by-step prohibition of all customer-directed give-ups. Step-by-step implementation, over a period of at least one year, would give firms an opportunity to adjust to the economic impact of such a change. We would, of course, expect continuation of bona fide agency-principal relationships between members for such services as clearing, floor brokerage and introducing of accounts on a disclosed basis.

The Costs and Revenues Committee is still continuing its work with respect to such matters as intra-industry rates and policy regarding institutional membership, and expects to report on these subjects at a later date.

If approved by vote of the membership, the new commission schedule and related amendments and rules would be the first revision of New York Stock Exchange rates in nine years.

Basic shifts are taking place in the nature of the securities business. It is imperative that our commission structure be responsive to the facts of life in today's marketplace.

In the letter of January 2 to the membership, it was noted that a major factor in the Board's endorsement of important structural changes at that time was that a network of practices in the industry are eroding the present minimum commission structure.

An intricate maze of give-ups, give-aways, reciprocal practices, manufactured participations in trades, transported trades moved from one exchange to another, and the like, have resulted in considerable leakage of the commission dollar.

Regulatory developments since January have underscored the need for taking action along the lines then recommended.

Shortly after we presented our January proposal, the SEC advanced an incompatible suggestion, its proposed Rule 10(b)-10, requiring that any give-up directed by an investment company must, in effect, be rebated to the institution. In a comment on that proposal, the Department of Justice questioned the necessity for and propriety of any minimum commissions. Then the SEC in advancing its proposed "interim" commission proposal in May, and requesting that the NYSE place it in effect by September 15, 1968, offered as an alternative, the abolition of minimum commissions on all orders above $50,000. The SEC's "interim" proposal quite apart from its serious effect on member firm revenues, would present severe operational problems.

As you know, SEC investigative hearings on the commission structure and related matters begin in Washington next week. Give-ups and reciprocal practices are among the topics the SEC intends to examine. Fortunately, the Exchange's formulation of policy on these matters began long before the scheduling of the present hearings. With the principles defined for restructuring commissions, and a new schedule near completion, the Exchange is in a solid posture.

The three policy decisions reached by the Board today, coupled with the commission schedule to follow, speak directly to the changing nature of the securities market and the questions raised by the SEC and the Justice Department. They embody a totally modernized approach to the way the membership charges for its services, parallel in spirit to the automation and other up-to-date techniques that have been introduced recently into such aspects of our business as market data communications, odd-lot handling, and clearance and delivery of securities.

A new commission structure along the lines of the three policy decisions reported above is bound to involve an overall decrease in member firm income on a given volume of business.

The Exchange is making detailed calculations of the economic effects of the possible commission changes on member firms, based on careful sampling studies and examination of Income and Expense reports. When the final commission schedule is developed, we will be in position to estimate its total costs and the effects on different types of firms, varying, of course, with the nature of each firm's commission business.

It should be noted that the "interim" commission schedule proposed May 28 by the SEC, which was figured on the 1966 Public Transaction Study, involved a reduction of approximately $110 million in gross member firm revenues. The reduction could be much greater on the basis of the membership's current volume and mix of business, and if allowance is made for revenue losses resulting from a discount to qualified nonmember brokers.

The need to restructure commissions comes at a time when the securities industry, which is characteristically cyclical in its level of activity, is at an all-time peak in volume of business. The industry is incurring heavy costs to gear itself for handling this volume. The best prospect for our membership to recover the immediate costs of a restructuring of commissions lies in fostering long-term growth in demand for the membership's services to the investing public.

The principles approved by the Board, and the commission schedule being prepared to carry them out, will encourage such long-term growth. In the long run, these changes may well present member firms an opportunity to attract additional business to the Exchange from nonmember brokers in this country and abroad, improving the position of the Exchange and its members. Such additional business would add to the depth and liquidity of Exchange markets, thus enabling the Exchange marketplace to do a better job for all investors who use it.

We will, of course, keep you informed of developments and hope before long to be able to submit, for a vote of the membership, a full commission schedule and related Constitutional amendments.

Robert W. Haack

APPENDIX V

INCOME OF MUTUAL FUND RETAILERS--TABLES AND FIGURES OF DISTRIBUTION FOR 1968 AND 1969

TABLE 1

DISTRIBUTION OF INCOME FROM MUTUAL FUND OPERATIONS AS A PER CENT OF GROSS INCOME

Income from Mutual Fund Operations as a Per Cent of Gross Income	Number of Firms (Frequency)	
	1968	1969
0 - 10	43	48
10 - 30	30	35
30 - 50	20	21
50 - 70	20	27
70 - 90	50	40
90 - 100	123	115
Total	286	286

Source: Data from questionnaires received from mutual fund retailers.

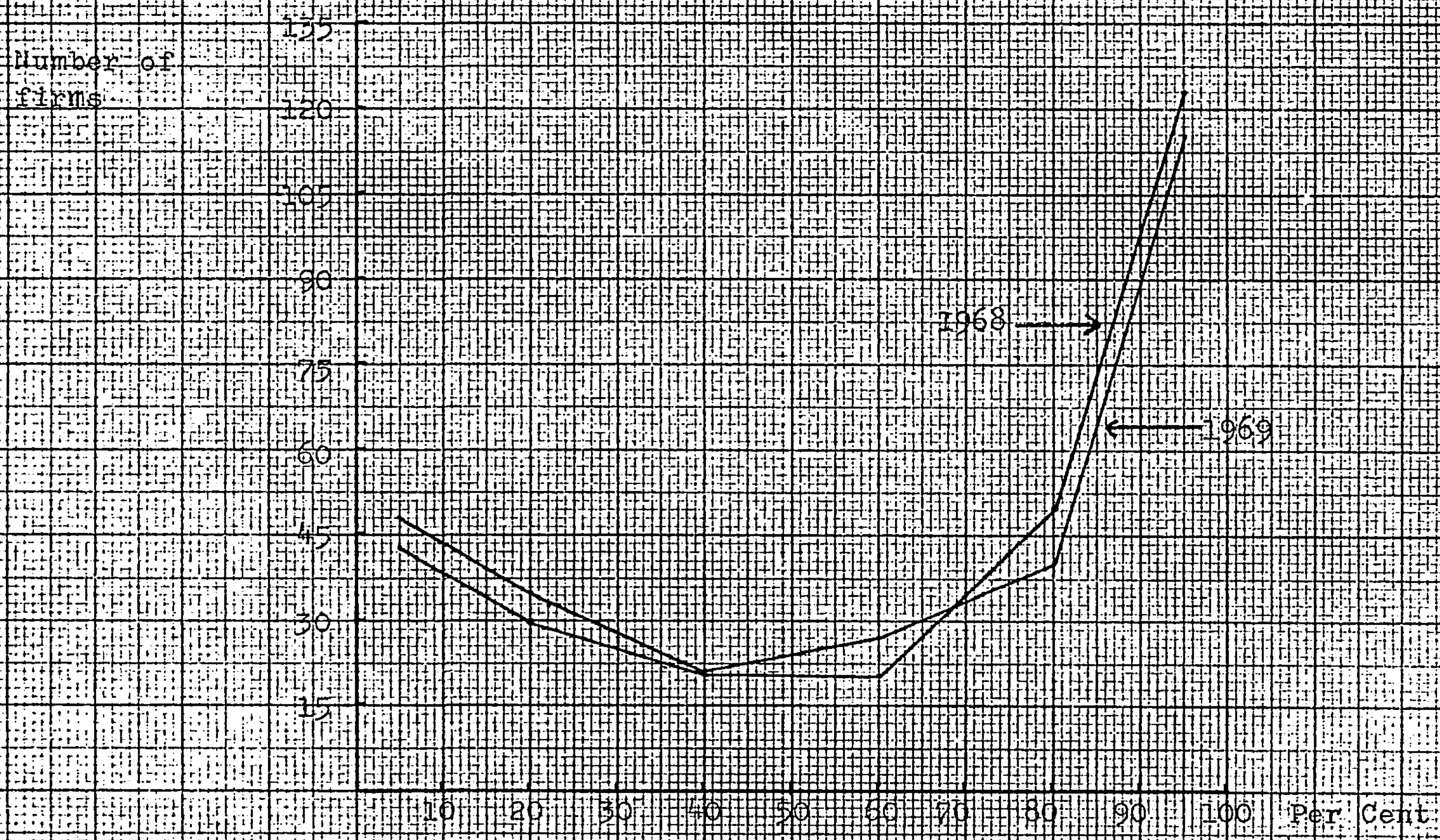

Figure 1. Income from mutual fund operations as a per cent of gross income, 1968 and 1969.

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TABLE 2

CUMULATIVE DISTRIBUTION OF INCOME FROM MUTUAL FUND OPERATIONS AS A PER CENT OF GROSS INCOME

Income from Mutual Fund Operations as a Per Cent of Gross Income	Number of Firms (Cumulative Frequency)	
	1968	1969
Less than or equal to 0	0	0
Less than or equal to 10	43	48
Less than or equal to 30	73	83
Less than or equal to 50	93	104
Less than or equal to 70	113	131
Less than or equal to 90	163	171
Less than or equal to 100	286	286

Source: Data from questionnaires received from mutual fund retailers.

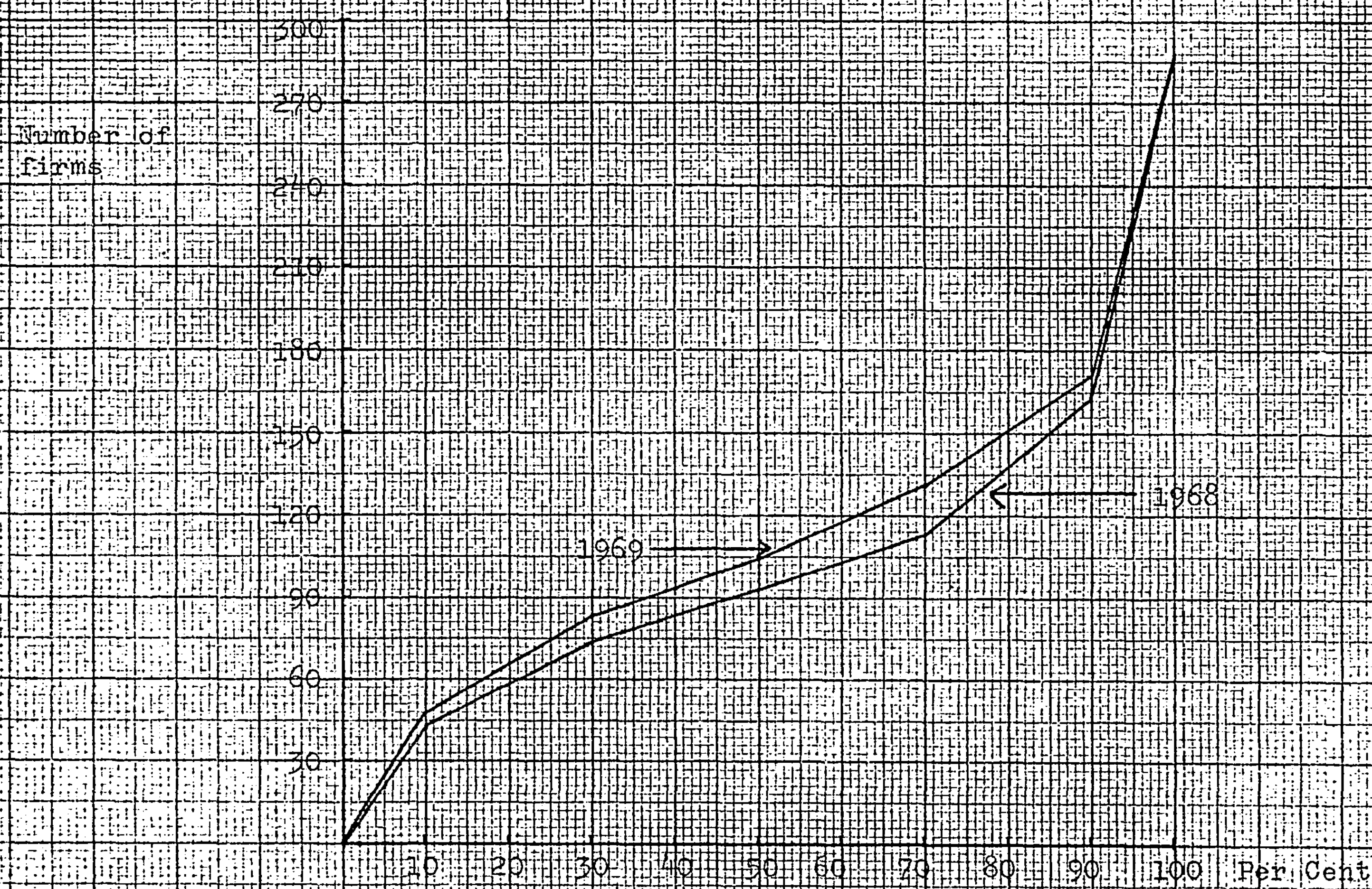

Figure 2. Cumulative distribution of income from mutual fund operations as a per cent of gross income, 1968 and 1969.

TABLE 3

DISTRIBUTION OF GROSS INCOME
FROM MUTUAL FUND OPERATIONS

Gross Income (Thousands of Dollars)	Number of Firms 1968	1969
0 - 50	127	131
50 - 100	50	53
100 - 200	38	30
200 - 300	11	15
300 - 500	14	11
500 - 1000	16	20
1000 - 1500	10	7
1500 - 2000	3	2
2000 - 2500	1	2
Over 2500	16	15
Total	286	286

Source: Data from questionnaires received from mutual fund retailers.

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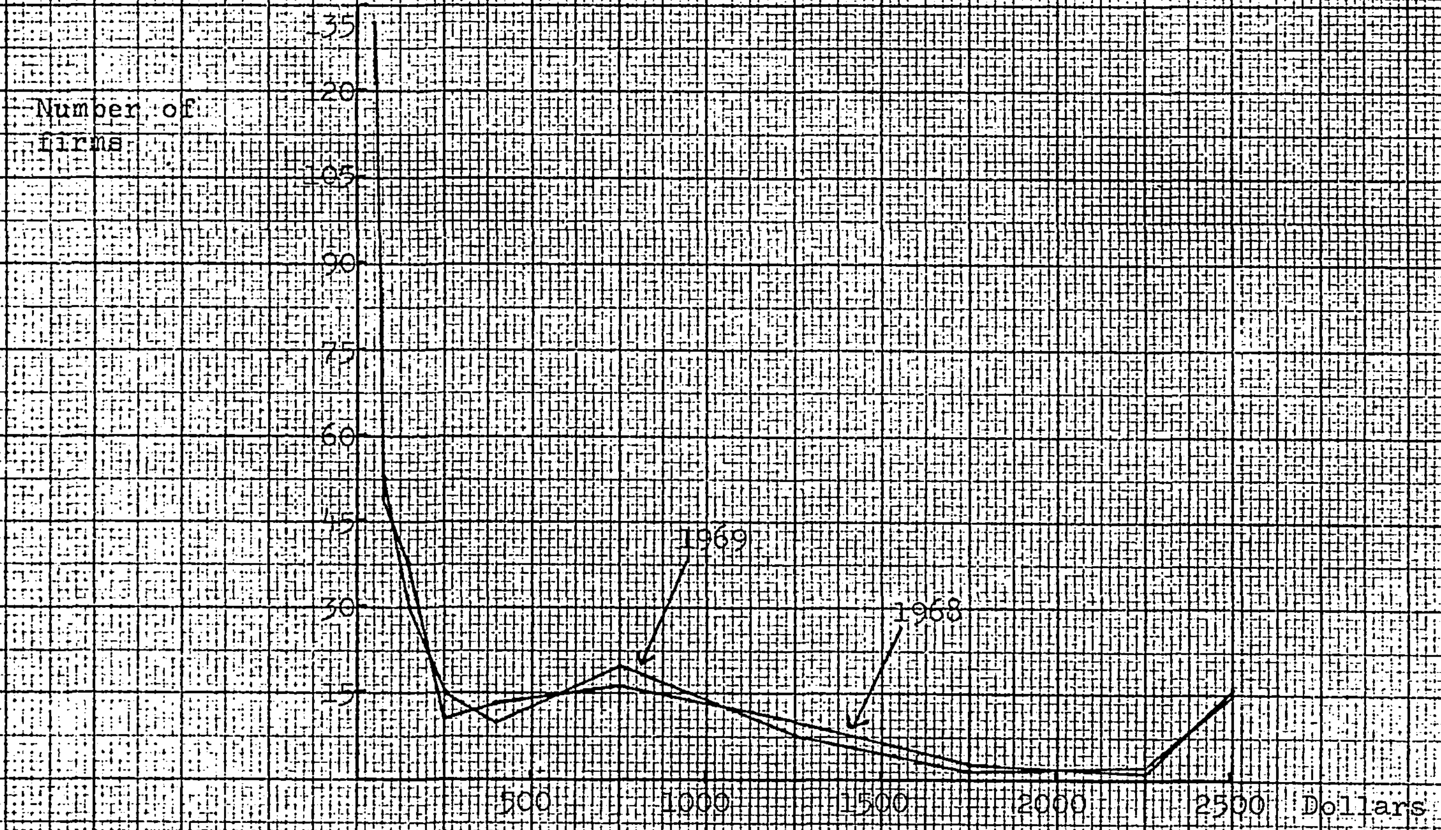

Figure 3. Gross income in thousands of dollars from mutual fund operations, 1968 and 1969.

TABLE 4

CUMULATIVE DISTRIBUTION OF GROSS INCOME FROM MUTUAL FUND OPERATIONS

Gross Income (Thousands of Dollars)	Number of Firms (Cumulative Frequency)	
	1968	1969
Less than or equal to 0	0	0
Less than or equal to 50	127	131
Less than or equal to 100	177	184
Less than or equal to 200	215	214
Less than or equal to 300	226	229
Less than or equal to 500	240	240
Less than or equal to 1000	256	260
Less than or equal to 1500	266	267
Less than or equal to 2000	269	269
Less than or equal to 2500	270	271
Less than or equal to ∞	286	286

Source: Data from questionnaires received from mutual fund retailers.

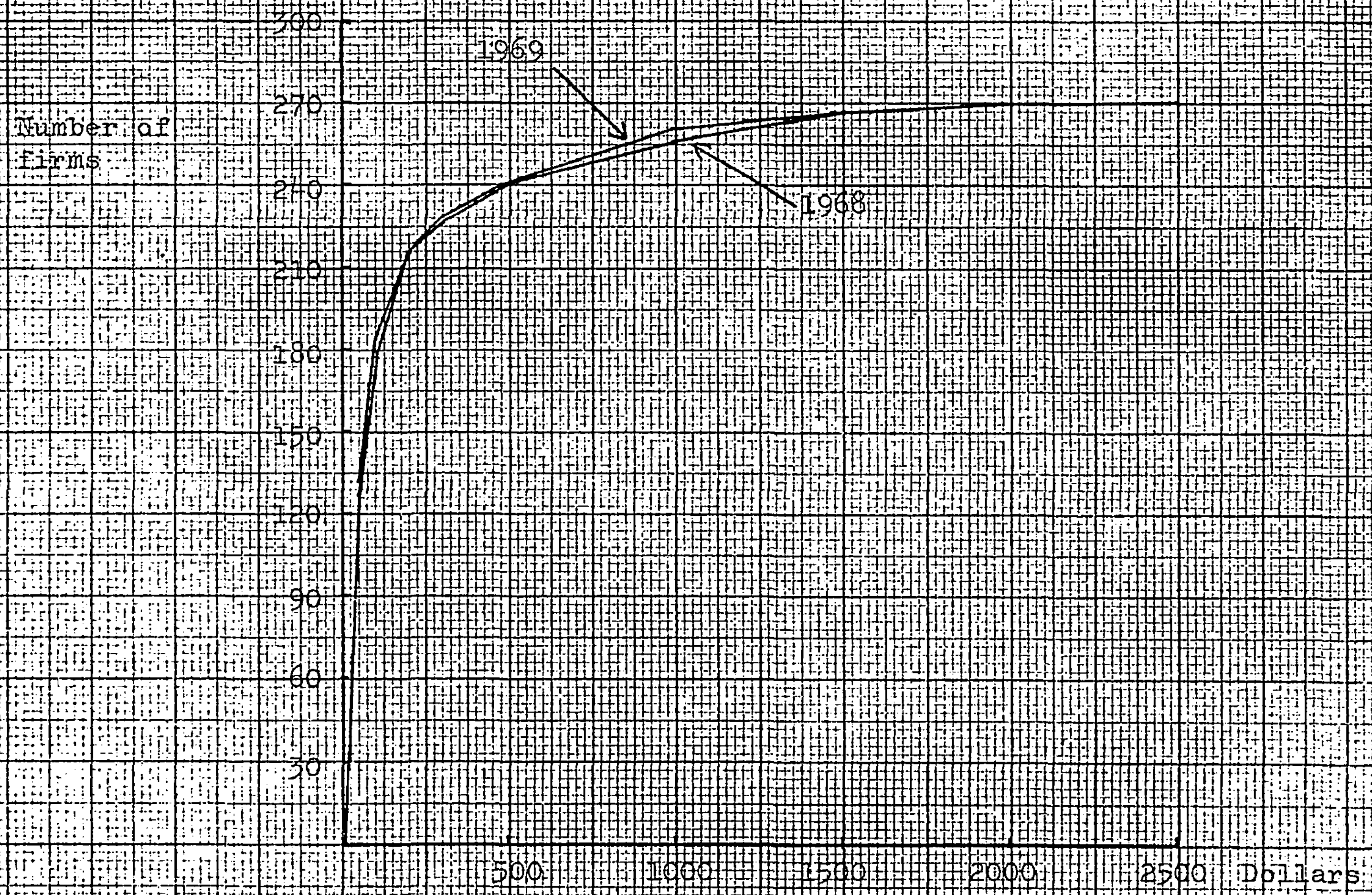

Figure 4. Cumulative distribution of gross income in thousands of dollars from mutual fund operations, 1968 and 1969.

APPENDIX VI

SECURITIES INDUSTRY QUESTIONNAIRE OF THE INDEPENDENT BROKER-DEALERS' TRADE ASSOCIATION

Independent Broker Dealers' Trade Association

472 Bridge Street
Springfield, Massachusetts 01103
Telephone (413) 781-3800

Raymond W. Cocchi
President

James C. Butterfield
Treasurer

December 1, 1969

Dear Member:

We are pleased to enclose the results of a recent survey, in which your firm participated.

As you know, this survey was prompted by members of Congress who have expressed deep concern over the continued profitability of independent brokers and dealers, particularly in the face of loss of "give-ups", pending Mutual Fund Legislation, and rising costs in maintaining small businesses.

Thanks again for your cooperation, and we will keep you advised.

Sincerely,

Ray

Raymond W. Cocchi
President

tc

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Independent Broker Dealers' Trade Association

472 Bridge Street
Springfield, Massachusetts 01103
Telephone (413) 781-3800

Raymond W. Cocchi
President

James C. Butterfield
Treasurer

TOTAL REPLIES - 189

PERSONAL AND CONFIDENTIAL

SECURITIES INDUSTRY QUESTIONNAIRE
FOR NON-NYSE MEMBERS

INSTRUCTIONS: Answer all questions you can in your best judgment. Questions have been double spaced to allow room for additional remarks, if any.

Answer Space		GENERAL
Average 15 yrs.	1.	How long have you been in the securities business?
	2.	Your business is in Rural Area 56, Metropolitan Area 126, Eastern Part of USA 72, Midwest 49, West 43? Non U.S. 4
	3.	Your business volume is roughly OTC Stocks 13 %, Third Market 6 %, Mutual Funds 70 %, Life Insurance 6 %, Give Away NYSE 4 %, Misc. 1%.
Yes 142 No 42	4.	Do you compete against a NYSE branch office?
Order Takers 130 Sm. Investors 27	5.	Would the NYSE branch in your area be classified as order-takers, or do they spend their time with small investors?
Yes 115 No 68	6.	Do you have contacts with small companies that need financing?
Yes 94 No 93	7.	Have you participated in new issues in the past?
Yes 100 No 84	8.	Are you interested in new issues for your clients?
Yes 156 No 20	9.	Do you feel the S.E.C. is anti-small business?
Yes 114 No 47	10.	Do you feel the N.A.S.D. is anti-small business?
Yes 20 No 173	11.	Did you join a regional exchange in the last year?
Yes 11 No 9	12.	Has your arrangement been satisfactory?
Yes 155 No 23 Average 76%	13.	Have you had a dramatic increase in overhead since 1966? Roughly what percentage?
Inc. sup. 129 Prom. costs 43	14.	Is much of this due to increased supervision, bookkeeping and regulation snowballing, or is it due to promotion costs?
Yes 183 No 6	15.	Do you feel Congress is uninformed regarding the "grass roots" of the securities industry?

Answer Space		
Yes 74 No 106	16.	Do you feel like part of the industry? That is, are you posted on the effects of new regulations and new legislation prior to their enactment?
	17.	Do you give fringes to back office personnel? Yes 106 No 61 Salesmen? Yes 98 No 68
Average 61%	18.	What percentage of commissions are paid to your salesmen?
Yes 0 No 187	19.	After the sale, when a client has a time-consuming problem, do you charge for your time?

MUTUAL FUNDS

Yes 175 No 10	1.	Do you have problems with Mutual Fund custodian banks?
Yes 140 No 41	2.	Do your clients blame you for custodian bank foul-ups?
Average 15%	3.	What percentage of your time do you spend correcting custodian bank foul-ups?
Yes 136 No 25	4.	Should this problem be sent to Congress as one of the reasons that banks should not be permitted to enter the Mutual Fund business?
Yes 58 No 115	5.	Would you survive if Mutual Fund commissions are reduced to a maximum of 5%?
Yes 126 No 42	6.	Would you reduce salesmen's commissions?
Yes 96 No 80	7.	Would you reduce client services?
Yes 143 No 28	8.	Would you survive if the "front-end-load" on contractuals is abolished?
	9.	What part of the Mutual Fund Bill now pending in Congress would effect your business most? Sales charge 171, "Front-end-load" 41, Banks entering Mutual Fund field 109, Management fees 15.
Yes 166 No 17	10.	Did your firm receive "give-ups" or "reciprocal" from Mutual Funds prior to December 5, 1968?
Average 1.44%	11.	Approximately what percentage of "give-ups" or "reciprocal" did you receive in relation to your Mutual Fund sales?
Yes 23 No 160	12.	Have you received "give-ups" or "reciprocal" since December 5, 1968?
Yes 8 No 152	13.	Has the elimination of "backward pricing" of Mutual Fund purchases helped your clients?

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INDIVIDUAL SECURITIES

Answer Space		
Do 126 Do Not 61	1.	I do/do not handle individual securities transactions.
Yes 54 No 7	2.	If you do not, would you provide this service for your clients if you did not have to become involved in execution, confirming, transfers, dividends, etc., and were paid a portion of the commission?
Yes 36 No 137	3.	Do you feel that the proposed 33 1/3% commission "access" to the New York Stock Exchange for non-members is adequate?
Average 52%	4.	If you answered no, what percentage would be adequate?
Yes 72 No 20	5.	Do you agree with the pending Senate bill that would raise Regulation A offerings from $300,000 to $500,000?
Encouraged 7 Discouraged 51	6.	Have "wholesale quotes" encouraged or discouraged your merchandising efforts in OTC stocks?
Yes 24 No 154	7.	Do you make markets in securities?
Average 21	8.	If so, in how many stocks do you make markets?
Local 22 National 10	9.	Are your markets made in local issues or national issues?

ADDITIONAL REMARKS

APPENDIX VII

LETTERS FROM STOCK EXCHANGES

NEW YORK STOCK EXCHANGE
ELEVEN WALL STREET
NEW YORK, N. Y. 10005

ALLEN O. FELIX
MANAGER, SCHOOL AND COLLEGE RELATIONS

February 4, 1970

Mr. George M. Charles
College of Business Administration
The University of Oklahoma
Norman, Oklahoma

Dear Mr. Charles:

Your letter to the President of the Exchange, Mr. Robert W. Haack, was referred to me. I am enclosing materials which will give answers to many of your questions. Some of the data for 1969 have not been tabulated yet. If you will contact me later for specific data, of a type as included in our FACT BOOK, I will try to get them for you for the year 1969.

One source you might check is the New York Times and several financial magazines which feature year-end facts and figures. Also, of course, there are several services which compile data of all sorts -- for example, Standard & Poors, Moodys, Forbes, etc. If your library does not have these, you may want to check with some of our member firms who will probably let you refer to their copies.

The answer to your question #3 is no; however, as carried in press releases recently, the whole concept is under detailed study at this time. Changes may be forthcoming within a few weeks or months.

The Exchange does not allow foreign members, question #5. Anything is possible but this change is not among the ones being carefully considered at this time. Incidentally, may I suggest that you get a copy of our Constitution. This can be ordered from Commerce Clearing House, 4025 W. Peterson Avenue, Chicago, Ill.

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The S.E.C. is involved in several studies relating to questions you asked. Check with them to see what data or information they will release. Regional exchanges are the best source for some of your questions.

Cordially yours,

Allen O. Felix

Allen O. Felix

AOF/s
Enclosures

2

American Stock Exchange

242

86 Trinity Place
New York NY 10006
212 964-3200

Information Services Division

March 18, 1970

Mr. George M. Charles
College of Business Administration
Department of Finance
The University of Oklahoma
Norman, Oklahoma 73069

Dear Mr. Charles:

It is with some embarrassment that I reply to your letter to Winsor H. Watson, Jr. of March 11, 1970. Mr. Watson, at the time that you first corresponded with the Exchange, had asked me to research the data that you had requested and to forward the materials on to you.

We have not forgotten your request. Rather, I had sent copies of your original letter to a number of divisions within the Exchange, since many of your questions dealt with areas unfamiliar to me.

I am attaching the replies to most of these questions; and additional source materials from which you can gather more complete data.

If I can be of further service, please do not hesitate to call on me directly.

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In the meantime, thank you for your interest in the American Stock Exchange.

Cordially,

John C. Ford
Manager,
Education Services

JCF:ahc
Enc.

No. 1
Question: Dollar and share volumes on the Exchange for the period 1960-1969.

Answer: This information is available in the attached list, "Stock Trading Statistics" (2/5/70) and also in the Amex Databook, likewise enclosed.

No. 2
Question: Number of block trades per year for the period 1960-1969. Is it possible to break down the block trades transacted for mutual funds and those for other customers?

Answer: A block transaction breakdown is available only from 1966; and memorandums with this information are likewise attached (H. Vernon Lee). Other relevant material on this subject will be found in the Amex Databook.

No. 3
Question: Do you accept subsidiaries of mutual funds and other institutional investors as members of the exchange? If you do, when did the practice begin? If you do not, do you propose to in the future?

Answer: No, we do not accept subsidiaries of mutual funds and other institutional investors of the Exchange; although same is being considered under general question of institutional membership.

No. 4
Question: Could you send me a booklet or brochure giving the history of your exchange which would include the various types of members and the functions of each?

Answer: I am enclosing a number.

<u>No. 5</u>

Question: Does your exchange accept foreign members? If you do, when did the practice first begin? If you do not, is this possible in the future?

Answer: The Exchange has had Canadian members for years. Although we have had foreign associate members over the years, we have none now. It is possible again in the future, depending on the outcome of public ownership and other questions of access to the market now under study...though this presents problems of surveillance at such a great distance.

<u>No. 6</u>

Question: What steps have you taken to make sure that the ban on customer-directed give-ups is enforced? What is to stop a member from splitting commissions with non-members if directed to do so by a mutual fund?

Answer: Article 6 of the Amex Constitution specifically forbids this practice (copy on request); and it is enforced through periodic checks by examiners who visit members firms and survey records. As for part 2 of your question, the rule alone and observance of same is the guideline which would stop a member from splitting commissions; and periodic checks by auditors would bring same to light.

<u>No. 7</u>

Question: The number of stocks on your exchange that are dually listed for the period 1960-1969.

Answer: See attached additions (memo: Joseph Kenrick) to information available in enclosed <u>Amex Databook</u>.

<u>No. 8</u>

Question: Have you always prohibited your members from splitting commissions with non-members? When was this rule first put into effect?

Answer: Yes. So long ago, the date is not available.

No. 9

Question: Have you any information on when the practice of customer-directed give-ups first began? Is it possible to determine the number of shares and dollar volume directed to regional exchanges originating from mutual fund orders during the period 1960-1968? If this is possible, I would imagine the amount of commission generated by these orders could be determined.

Answer: No, but the practice first began during the last five-ten years. Would suggest that a check of regional exchanges would provide more accurate answers since information is not available here.

No. 10

Question: Where is it possible to obtain an up-to-date study of the Third Market?

Answer: Suggest Weeden & Co., or First Boston Corporation. Also, SEC in Washington.

PACIFIC COAST STOCK EXCHANGE

618 So. Spring Street
Los Angeles 90014

301 Pine Street
San Francisco 94104

Los Angeles
April 14, 1970

Mr. George M. Charles
The University of Oklahoma
Norman, Oklahoma 73069

Dear Mr. Charles:

Please accept our apologies for the delay in responding to your set of questions. Enclosed is a 1969 annual report which will cover a major portion of the questions you have detailed.

Unfortunately, we are unable to answer certain questions you have asked as our records are either maintained in a different manner or do not go back far enough to prove conclusive for your apparent needs.

I shall go through your 13 questions and indicate either the answer or where it may be found:

1. See booklet "Pacific Coast Stock Exchange Story."
2. See attached volume figures.
3. See attached breakdown.
4. See attached.
5. See annual report.
6. See annual report.
7. Yes.
8. Yes. 1965.
9. Annual report. Any company in the United States which meets our basic specifications. See annual report for requirements.
10. 173 PCSE member firms, 89 of which are members of the NYSE, and 84 members of the AMEX, Midwest or local members. 17 are institutional members (see attachment).
11. In the 1930's. We do not have volume figures available.
12. Our rules are enforced by our compliance and surveillance function, and hopefully there are no loopholes.
13. As evidenced by our volume figures, the give-up ban has not caused a decline in volume on the PCSE.

I hope the attached information is useful and would very much appreciate receiving a copy of your conclusions. If we can be of any further assistance, please do not hesitate to contact us directly.

Sincerely yours,

Philip L. Thomas
Vice President

	Volume by Year	Value
1969	171,884,085	$5,513,669,262.01
1968	143,276,875	5,242,049,849.30
1967	114,323,089	4,538,551,441.32
1966	88,931,688	3,524,017,989.51
1965	62,440,906	2,179,923,577.89
1964	56,216,672	1,800,041,760.00
1963	53,136,243	1,542,442,811.00
1962	50,565,911	1,097,208,446.00
1961	73,198,461	1,279,815,968.00
1960	44,853,085	883,355,671.00

Number of New Listings

1960	32
1961	36
1962	25
1963	36
1964	38
1965	40
1966	64
1967	78
1968	83
1969	121

	Block Transactions	% of Total Shares
1969	15,289	36
1968	12,580	32
1967	9,226	33
1966	6,079	33
1965	3,562	20

	1000 - 5000	5,000-10,000	10,000 & up
1969	12,363 12%	1,529 5%	1,397 19%

BOSTON STOCK EXCHANGE
ESTABLISHED 1834

JAMES E. DOWD
PRESIDENT

53 STATE STREET
BOSTON, MASS. 02109
AREA CODE 617 523-5380

February 5, 1970

Mr. George M. Charles
College of Business Administration
Department of Finance
University of Oklahoma
Norman, Oklahoma

Dear Mr. Charles:

I have your letter of January 24, in which you request certain data in connection with the preparation of your doctoral thesis.

I succeeded Frederick Moss as President of the Exchange on July 1, 1969 and I will attempt to answer most, if not all, of your inquiries, following the order in which you presented them.

1. Enclosed is a reprint of the Boston Globe which appeared some time in early 1967. There is also enclosed a Xerox copy of an article that appeared in "Boston Magazine" in September 1965, which provides a fairly detailed history of the Exchange.

2. Exhibit 1 is the volume by year from 1960 through 1969.

3. Exhibit 2 is a schedule of the number of securities fully listed on this Exchange during the period 1960 to 1969. Bear in mind, however, that in addition to those fully listed, we also maintain trading markets in approximately 550 dually traded issues.

4. I am unable to supply figures on the block trading or the percentage of blocks versus total volume for these years. Exhibit 3 is an excerpt from an in-house study conducted for the period February 1 through October 23, 1969 on trades of more than 10,000 shares.

5. The number of authorized seats in 1960 was 102; on November 9, 1967, the authorized number was increased to 112 and on October 9, 1968 the 112 seats were split 2-for-1, giving us a present authorized 224 seats. Of this figure, ten are held in the treasury. There are 181 seatholders, some of whom hold two seats and for tax or other reasons have not sold their split or second seats as yet.

6. The present cost of a seat is $14,000 (post split). By way of explanation, the auction market for a seat on Boston in 1960 was about $2,000 and remained in this range until late 1965. Between early 1966 and October 1968, the auction market price was increased to a high of $28,000. At that time, when the Governors voted a split of seats, they fixed the price of "second seats" at $14,000 where it will remain until all of the 214 available seats are outstanding. I would assume that at that time the price will then go on a supply and demand auction market.

7. The Boston Stock Exchange does accept foreign seatholders. In December, 1968, the Exchange received into membership a representative of German-American Securities, a wholly-owned subsidiary of the Dresdner Bank, Frankfurt, Germany. Since that time, we have received into membership alien seatholders representing Swiss and French interests and in November and December, 1969, we accepted four Japanese, representing domestic subsidiaries of Japanese firms. The reason for accepting the foreign applicants was the desire to broaden our possible sources of business. As you may know, in Germany it is customary for investors to purchase securities through their local bank and it made sense for the bank to join the Boston Stock Exchange through a domestic subsidiary, thereby saving its depositors additional expense and at the same time creating a profit center for the bank. I might add that the foreign memberships have been extremely successful.

8. The Rules of the Boston Stock Exchange at present do not permit subsidiaries of mutual funds or banks and insurance companies to become members. I do not foresee any change in this policy except perhaps to the limited extent proposed by the Midwest Stock Exchange in its recently circulated proposal to amend the Rules regarding membership and public ownership.

9. Four new sole listings were added during 1969, and we are hopeful that during 1970 we can attract ten additional sole listings.

10. Our membership covers a broad spectrum of the securities business from the Floor Broker, Dealer Specialist, small to medium regional firm to the large New York wire houses. In addition, our membership numbers (particularly among the newer members) a group of essentially mutual fund dealers who joined the Exchange after the abolition of the customer directed give-up in December, 1968.

11. I would be unable to determine when the practice of the customer directed give-up first began. There is no doubt that it became extremely prominent and much used (and abused) in the mid and late '60's. There is no question that the tremendous increase in volume on the Boston Exchange during 1967 and 1968 was accounted for by the customer directed give-up. Since its abolition, we have been studiously attempting to find ways and means of attracting new business and listings. The splitting of the seats and the acceptance of foreign members are two steps in this plan.

12. It is not possible for commissions generated on this Exchange to be split with non-members. We police this prohibition by our staff of field auditors and I am unaware of any loopholes in this absolute prohibition.

For your additional information, I am enclosing a reprint of articles which appeared in the December, 1969 issue of ISM, the magazine for investment professionals, as well as the January 3, 1970 issue of Business Week. Both of these articles deal with the regional exchanges and the problems that they have experienced with the end of the customer directed give-up.

I trust that the foregoing information and enclosures will be helpful to you, and I most certainly would appreciate reading a copy of your thesis upon its completion.

Very truly yours,

James E. Dowd

James E. Dowd
President

JED/cr
Enclosures

EXHIBIT 1

VOLUME & DOLLAR VALUE OF STOCKS TRADED ON THE B.S.E. FOR THE YEARS 1960-1968

	Volume	$ Value
1960	5,606,360	272,155,515
1961	6,268,720	318,519,633
1962	5,332,051	252,352,847
1963	5,595,436	274,085,531
1964	5,925,854	310,107,457
1965	7,143,002	382,403,133
1966	13,271,928	700,623,645
1967	20,084,162	1,091,604,173
1968	42,406,072	2,055,223,378
1969	~~[illegible]~~ 23,3[illegible],[illegible]15	N.A.

FULLY LISTED SECURITIES ON THE

BOSTON STOCK EXCHANGE

EXHIBIT 2

YEAR	STOCK	BONDS
1955	81	16
1960	69	14
1961	68	11
1962	62	10
1963	57	10
1964	54	10
1968	58	11
1969	57	11

BOSTON STOCK EXCHANGE
ESTABLISHED 1834

53 STATE STREET
BOSTON, MASS. 02109
AREA CODE 617 523-5380

June 20, 1970

Mr. George M. Charles
College of Business Administration
Department of Finance
The University of Oklahoma
Norman, Oklahoma

Dear Mr. Charles:

Your June 16, 1970 letter directed to Mr. Dowd has been referred to me for reply.

We have indicated on your enclosed sheet the volume and dollar value of stock traded for 1969.

We enclose a summary of block transactions of 2,000 shares or more for the years 1967, 1968 and 1969. No separate records were maintained for the years prior to 1967 so we are unable to even estimate what percent of the volume done on this Exchange was in the form of blocks.

We do not have any form of a yearly data book or written explanation on the functions of members of the Exchange. However, if we can answer any specific questions, we would be happy to do so.

Very truly yours,

Walter E. Cummings

Walter E. Cummings
Secretary

WEC/c
En cls.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

888 SEVENTEENTH STREET N. W. WASHINGTON, D. C. 20006

January 30, 1970

Mr. George M. Charles
College of Business Administration
Department of Finance
The University of Oklahoma
Norman, Oklahoma, 73069

Dear Mr. Charles:

I'm afraid that we do not have any of the statistical information on customer directed give-ups that you need for your doctoral dissertation. I would suggest that you contact the regional exchanges directly for this type of information.

I am enclosing your letter in case you would like to use it as a basis for inquiries to other organizations.

Sincerely,

Karen Ray

Karen Ray
Information Department

Enclosures

APPENDIX VIII

REGULATORY ACTS AND ORGANIZATIONS OF THE SECURITIFS INDUSTRY

REGULATORY ACTS AND ORGANIZATIONS OF THE SECURITIES INDUSTRY

In the course of this study, certain legislation and organizations are repeatedly mentioned. Some knowledge of the basic objectives of these acts and organizations is desirable since they are all related, in varying degrees, to the problem of customer-directed give-ups.

The Securities Act of 1933

This was the first of the securities acts and resulted from congressional investigations following the collapse of the stock market during 1929-1932. The basic objective of the 1933 Act is to provide full disclosure of relevant information to the public regarding the issue of new securities. The act makes no attempt to control the quality of any issue or the method of its distribution. Some of the main features of the Securities Act of 1933 follow:

1. The act applies to all interstate offerings of new securities in excess of $300,000. Those under $300,000 may be exempt from most of the provisions of the act with the consent of the SEC. Also exempt are government bonds, bank stocks, securities offered privately to a limited number of people, short-term commercial paper and securities issued by nonprofit organizations.

2. Securities must be registered with the SEC before they are offered to the public. The registration statement provides legal, technical and financial information about the issuer. There is also a prospectus which summarizes this information for public use. If any of the information is misleading or inadequate the SEC is required to delay or stop the public offering.

3. After the registration has become fully effective the securities may be offered if a prospectus accompanies the offering. A preliminary prospectus, however, may be offered during the waiting period.

4. If the registration statement or prospectus contains misleading information, any purchaser who suffers a loss may sue for damages. Severe penalties are imposed for violation of the act.[1]

The Securities Exchange Act of 1934

The act extended Federal regulation of the securities industry to include trading in securities already issued. The principal features of the act are:

1. It established the Securities and Exchange Commission to administer both the 1934 Act and the 1933 Act which had been administered by the Federal Trade Commission.

2. It provided for registration and regulation of all stock exchanges of substantial size. The SEC was given authority over

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[1]John C. Clendenin and George A. Christy, Introduction to Investments (New York: McGraw-Hill Book Company, 1969), pp. 293-295.

listing and delisting of securities, short selling, floor trading techniques and general rules and practices of the exchange.

3. Listed companies of the exchanges must file registration statements and financial data with the SEC; periodic reports must also be supplied.

4. All officers, directors and major stockholders of a corporation are required to file monthly reports of any changes in their holdings of the corporation's stock. Short term profits on company stock transactions must be surrendered to the corporation if stockholders take legal action. This feature of the act provides control over corporate insiders.

5. Proxy requests and practices are subject to the SEC control.

6. All securities brokers and dealers must register with the SEC whether or not they are affiliated with stock exchanges.

7. The 1934 Act prohibits manipulation or any fraudulent practices in securities transactions.

8. The Board of Governors of the Federal Reserve System was given the power to control margin requirements.[2]

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[2]Ibid., pp. 295-297.

The Investment Company Act of 1940

In addition to the Securities Act of 1933, and the Securities Exchange Act of 1934, investment companies are subject to the Investment Company Act of 1940. The act was passed by Congress after an investigation revealed, among other facts, that many investment companies had been run more for the benefit of the promoters than for the owners. Many investment companies had been organized with weak capital structures and unsound investment policies. Excessive debt had left these companies vulnerable to business depressions. There was rampant investment in speculative securities which led to severe losses. Excessive salaries and fees had been paid to investment company managers. The important provisions of this act are:

1. A registration statement must be filed with the SEC by each investment company with more than 100 security holders. These must be annual reports to the SEC and quarterly reports to the stockholders.

2. The registration statement must give information on contracts for investment advisory service, which are subject to the annual approval of the shareholders. At least 40 per cent of the directors must be persons who are not employees or officers of the investment company or its investment adviser.

3. Each registered company must file a statement of its investment policy with the SEC. The investment in any company cannot exceed 10 per cent of its voting securities or 5 per cent

of the investment company's assets.

4. Open-end companies can issue only common stock with voting rights. A limited amount of bank loans may be contracted.

5. Sales of new securities must be in accord with the Securities Act of 1933 and the regulations of the National Association of Securities Dealers.

6. Securities and cash of registered investment companies must be deposited in the care of a bank or stock exchange firm. In addition, all individuals who have access to securities or funds must be bonded.[3]

The Securities and Exchange Commission

The SEC was created by the Securities Exchange Act of 1934. The major reason for establishing the SEC was to protect the investment public from losses owing to fraud, unethical acts or unfair competition. The major objectives of the SEC are as follows:

1. To adequately inform the public about securities traded in various securities markets. All securities sold to the public must be registered with the SEC except for specific exempt securities.

2. To provide for the registration of exchanges, in order to regulate their activities.

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[3]Ralph E. Badger, Harold W. Torgerson, and Harry G. Guthmann, Investment Principles and Practices (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1969), pp. 574-575.

3. To prevent manipulation in the securities markets by requiring information relative to inside trading.

4. To regulate the activities of investment companies and investment advisers by requiring their registration with the SEC.

5. To regulate the activities of brokers and dealers operating in the securities market.

6. To supervise the activities of the National Association of Securities Dealers.[4]

The National Association of Securities Dealers

The National Association of Securities Dealers is the only self-regulatory association of brokers and dealers. The major objectives of the NASD are as follows:

1. To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, and to encourage and promote among members observance of Federal and state securities laws.

2. To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business.

3. To adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and

[4] Frederick Amling, Investments: An Introduction to Analysis and Management (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1970), pp. 252-253.

practices, and in general to promote just and equitable principles of trade for the protection of investors.

4. To promote self-discipline among members, and to adjust grievances between the public and members, and between members.

The NASD maintains its authority by means of a rule which forbids any member to allow a dealer's concession to, or receive one from, any nonmember firm on any new issue or secondary offering or over-the-counter transaction. Since these transactions are important to most firms' existence, memberships must be kept in good standing.[5]

The Investment Company Institute

The Investment Company Institute was founded in 1941. It was formerly the National Association of Investment Companies. The ICI represents mutual funds, their underwriters, managers, and shareholders in matters of legislation, regulation, taxation and various other areas. The Institution provides a source for information about the mutual fund industry, and serves as spokesman and fact-finder in many areas affecting its members, their shareholders and the investing public.

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[5]Wilford J. Eiteman, Charles A. Dice, and David K. Eiteman, The Stock Market (New York: McGraw-Hill Book Company, 1966), pp. 55-57.

The Independent Broker-Dealers' Trade Association

This association was formed in 1966 to protect and assert the rights and interests of independent brokers and dealers who are not members of the New York Stock Exchange. Approximately 3000 of the 4000 or more registered brokers and dealers in the U.S.A. are eligible for membership. The efforts of the association have been directed to issues relating to mutual fund legislation, the abolition of customer-directed give-ups, proposed access to the NYSE for non-members, and changes in the commission rate structure.