May 19, 1966

Mr. G. Keith Funston, President
New York Stock Exchange
Eleven Wall Street
New York, New York

Dear Mr. Funston:

This letter refers to the proposals outlined in your letter of November 11, 1965, and to the subsequent meetings with the Commission on November 24, 1965 and March 26, 1966, in which you set forth the purpose of proposed changes in the commission rate structure of the Exchange.

GIVE-UPS AND COMMISSION SPLITTING

Your proposal contemplated that members could "give-up" part of their commission to another member if such other member performed a function with respect to the order. Your Costs and Revenues Committee tentatively proposed that an "originating" broker would be permitted to share commissions with other members, apparently at the direction of a customer, to the extent that such other firm performed certain designated functions in connection with the order. Your proposal, however, restricted the amount given up to not in excess of 50% of the commission on the entire order "less any necessary expenses payable to other members for clearance, floor brokerage, etc. at the customary rates." You explained that all of the floor brokerage would be retained by the executing broker.

Your committee was prepared to consider a discount to nonmember brokers of 25% of the minimum nonmember commission rate. It was the committee's objective to provide access to the Exchange market for the public business of bona fide nonmember brokers. In our discussions, you explained that this proposal would enable the Exchange to attract institutional business from Regional Exchanges by permitting institutions to transmit their orders through nonmember brokers who would forward them to a member firm for execution. The nonmember broker would receive a 25% discount which it would not be permitted to share with the public customer. In our response to you on December 22, 1965, we stated that your proposals did not resolve the problem of "give-ups" in a thoroughly adequate manner. We further noted:

"* * * It is clear from your letter and from subsequent discussions that under your proposal members would continue to share in Exchange commissions as extra compensation for mutual fund sales although it might appear that technically they would provide services to the executing firm in originating or transmitting orders. In reality, however, any services that such firms would perform would seem to be unnecessary for the execution of the order and for the most part would create additional paperwork merely to justify a give-up.

"Absent a countervailing showing, it would appear that sharing in commissions, in the sense of providing rewards that are unrelated to the execution of transactions for bona fide customers, is not an appropriate practice. Such arrangements should be distinguished from the situation in which a broker-dealer is selected by his customer to execute an order and from the performance by other broker-dealers of appropriate and valuable services in connection with the transaction.

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"We are generally in accord with the Committee's view that certain non-member broker-dealers who cause their customers orders to be brought to the floor through a member should be entitled to compensation for their services in connection with the execution of the order by appropriate sharing of the commission. If, however, arrangements are made for such sharing of commissions, they should be so confined that they cannot be used as a vehicle for perpetuating or extending improper give-up practices and consequently the measures discussed above with respect to the splitting of commissions among members should be equally applicable to any sharing of commissions with non-members."

On the basis of our subsequent discussions with you, we believe that the two Exchange proposals described above, will have the effect of continuing and even expanding the deleterious aspects of the give-up on the New York Stock Exchange without any countervailing benefit. You expressed the view at our meetings and in staff discussions that you did not direct your attention to the problem of the merchandising of mutual fund shares which

arises out of directed give-up practices; nor did you consider the efficiency, from a cost point of view, of members duplicating or multiplying the work which would have to be done by the executing broker in connection with the order.

It is, therefore, appropriate for us to restate our position on give-ups and to delineate the kinds of commission splitting which we believe should be prohibited. At the outset we should restate our belief that the commission should fairly compensate a broker for the services which it performs. Assuming that a fixed minimum commission schedule is necessary and appropriate to effective and efficient operation of the Exchange, it is our view that give-ups and other similar arrangements which directly or indirectly arise out of customer direction or are for the customer's benefit are inconsistent with this premise and have the effect of providing a rebate. Such rebates are prohibited by Exchange rules. A rate structure should also provide equitable treatment for various classes of customers whose use of Exchange facilities is basically similar. As the Exchange rules recognize, it should not encompass rebates directly or indirectly to particular classes of customers. Such rebating is not only discriminatory but raises questions as to the propriety of the commission rate structure itself. A customer directed give-up is inconsistent with all of these principles. Not only does it deprive brokers of a portion of their commissions but it indirectly operates as a rebate in favor of those customers who happen to be able to derive a benefit from directing brokerage commissions to member firms having no meaningful participation in the execution of the orders. This discriminatory effect is aggravated where the benefits of the rebate flow not to the customer itself but to others, such as investment managers who are in a position to direct the customer's brokerage. Furthermore, the availability of indirect rebates through customer directed give-ups creates various distortions and artificial devices in the securities markets which are designed to facilitate a wider distribution of give-ups but in the process may interfere with the orderly functioning of the markets and the most effective execution of customers' orders. The directed give-up also seriously complicates the administration and assessment by the Exchange and the Commission of the reasonableness of commission rates since commissions received and retained cease to be related to the expenses incurred for services rendered in the execution of brokerage orders (or indeed, the commission business) on the Exchange.

To avoid these problems, the services for which a participating broker is compensated should (a) be necessary for the completion of the transaction, (b) involve functions not performed by the transmitting or executing broker, and (c) not be directed by a public customer.

Under your tentative proposal, an executing broker, at the direction of a customer, would be permitted to split the commission among an indeterminate number of clearing firms, thereby creating unnecessary and duplicative paper work. This situation would be even more anomalous if the executing broker is a clearing member of the Exchange. Admittedly, the paper work done by a series of brokers who were not involved in the execution does involve costs on their part. However, the incremental costs to an executing broker or clearing firm for sending out confirmations representing the entire order and receiving all of the certificates is minimal, perhaps even non-existent. The additional costs to all the brokers receiving the give-ups for doing the same work is substantial. It is our position that the fact that the recipients of the give-up may perform a function which is costly to them does not justify the give-up where this function does not appreciably reduce the expenses borne by the executing and/or clearing broker.

We have similar difficulties with the Exchange's tentative proposal, as outlined above, for splitting commissions with nonmembers. In our view this proposal would provide a means for managers of institutional portfolios to reward nonmembers for services (such as the sale of investment company shares) wholly unrelated to the execution of portfolio transactions by permitting the nonmember to perform an unnecessary order-transmitting function.

The Commission does not object to splitting commissions between members where the member originating the order is not equipped to perform the floor brokerage or clearing function. Under these circumstances, we would expect that the normal correspondent relationship would be continued, the rates negotiated, and the floor brokerage and clearance done in an efficient and necessary manner with appropriate compensation. Stated another way, we are not suggesting that bona fide correspondent arrangements by firms which result in a sharing of commissions would be inappropriate unless such arrangements and the commissions paid to the correspondent arise directly or indirectly out of customer request, direction, or understanding.

Conversely, it would not be appropriate for a transmitting or executing firm to use a wide variety of clearing firms in order to obtain a wide dispersion of commission income. Such a procedure would exacerbate regulatory problems and would constitute, in our view, an indirect rebate to the customer. Similarly, it would be inappropriate for a transmitting firm to use a wide variety of executing firms on a particular order. There are simpler and more direct methods other than by splitting commissions for members to fulfill among themselves obligations unrelated to the execution and consummation of commission transactions.

In short, the commission rate structure should provide for compensation for members' services and not permit rebating for customer benefit through the device of unnecessary or duplicative paper work. This letter of course is not addressed to the appropriate level of commissions or to the nature of services which are rendered generally by transmitting or originating firms which are covered by the minimum commission.

We raise no objection to splitting commissions arising out of the accommodation of a customer who places an order with a firm not regularly used by such customer when his regular broker is unavailable. Although in this instance a customer is directing the sharing of commissions the occasions for such arrangements are few and we do not believe a regulatory problem is created.

You have raised a question whether the approach set forth above will not result in the fragmentation of orders among many transmitting or executing firms by customers who seek to reward a number of brokers. Stated another way, you have questioned whether the Commission approach will destroy the "lead" broker concept. Institutions and others acting in a fiduciary capacity are under a legal duty to obtain the best execution for their principals. We believe that the direction of orders to firms by customers who hold such a fiduciary relationship to others should and normally will be done in a manner entirely consistent with their best execution. We can exercise our jurisdiction to that end.

Action should be taken by the New York Stock Exchange to prohibit give-ups and commission splitting through appropriate steps consistent with this letter. The Commission's position in this respect applies to all national securities exchanges and the over-the-counter market and the Commission will require simultaneous compliance in all markets. If it is necessary for the Commission to adopt rules to supplement those of the national securities exchanges with respect to this matter, it will do so in order to provide a comprehensive and uniform approach.

VOLUME DISCOUNTS

In your letter of November 11, 1965, you stated that your committee was sympathetic to the principle of volume discounts but that there are "complicated problems involved as to the application of such a discount." We agree with your evaluation. However, from our subsequent discussions it appears that most of the problems involved in devising a workable and useful volume discount arise because of the difficulty of providing for an equitable division of compensation between the transmitting firm, the executing firm, and the clearing firms. To a significant extent, this problem is a byproduct of the exchange proposals on give-ups and commission splitting. Further, we have serious doubts whether the kind of discount

tentatively suggested would not, because of the requirement that the order be executed through one broker on one day, restrict the discretion of customers and brokers as to the manner and timing of the execution of orders. We do not, and assume you do not, wish to place a customer in a position of having to execute substantial orders on one day in order to obtain a volume discount when prudent brokerage judgment might dictate otherwise.

We believe that the prohibition of give-ups will simplify the mechanical problems in devising a workable volume discount. We request the Exchange to reevaluate the amount of volume discount, the appropriate "breakpoints," and whether the discount should apply to transactions for a day, a week, or longer. We would expect, of course, as noted in our previous letter, that a volume discount would not place the regional stock exchanges at an unfair competitive disadvantage. Our staff is prepared to work with you in devising a volume discount which is workable and fair, and which provides for a reasonable discount for investors. We do not believe, however, that the development of an appropriate and effective volume discount should delay putting into effect promptly other aspects of the commission structure proposals.

Sincerely yours,

Manuel F. Cohen
Chairman