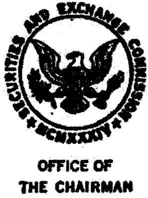

OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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Senator John Sparkman

Honorable John Sparkman
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

The Commission's policy statement on the Future Structure of the Securities Markets, which was issued on February 2, 1972, has recently been printed in pamphlet form. In view of your possible interest in having the printed statement for your files, I am taking the liberty of enclosing a copy.

Sincerely,

William J. Casey
Chairman

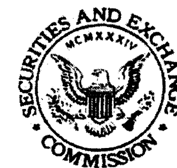
Enclosure

Statement of the Securities and Exchange Commission

on the

FUTURE STRUCTURE OF THE SECURITIES MARKETS

February 2, 1972



MEMBERS OF THE COMMISSION

WILLIAM J. CASEY, of New York, *Chairman* .... June 5, 1974
HUGH F. OWENS, of Oklahoma .... June 5, 1975
JAMES J. NEEDHAM, of New York .... June 5, 1973
A. SYDNEY HERLONG, JR., of Florida .... June 5, 1976
PHILIP A. LOOMIS, JR., of California .... June 5, 1972

A. JONES YORKE, *Executive Director*
RONALD F. HUNT, *Secretary of the Commission*

STATEMENT BY WILLIAM J. CASEY, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, UPON RELEASE OF THE COMMISSION'S POLICY STATEMENT ON THE FUTURE STRUCTURE OF THE SECURITIES MARKETS—FEBRUARY 2, 1972

The Commission is today issuing a policy statement which undertakes to speak not only to the subjects specified in the hearings held at the end of last year, but also to other still unresolved questions thrashed out in the Commission's hearings going back to 1968. Indeed, our statement on the future structure of the securities markets is the culmination of hearings and studies extending over the last decade. Yet, it is a beginning, for it points the way for the future, a future in which the securities industry and markets will perform an even more vital function in the economy of our country. Beyond that, we visualize the role that this industry has performed in our economy broadening to all the free economies of the world. In reaching our conclusions we tried to preserve that which is good to provide a foundation for improvement in the future.

The members of the Commission have a remarkable degree of unanimity in our view of what the securities markets should look like in the future and on what the Commission should do to guide and assist in evolving in this direction. This statement expresses the unanimous view of all the members of the Commission except that Commissioner Owens takes a different view at one point on the best method of achieving the goals which we all share. All of us fully agree on all the objectives and almost all the means of working toward markets which are public markets, staffed by professionals, retaining the confidence of individual investors that their interests are not neglected, and providing necessary depth and liquidity, by unification and by reliance on competition within the market structure, not outside it.

The policies which the Commission is adopting in this report focus on three paramount objectives. First, we want to make the relationships in the securities markets and their operation as simple, as direct, and as open as we can. They have become too complicated with too many transactions structured, contrived, and carried out in a particular place or in an unnatural way or without public discolsure—sometimes all three. The steps spelled out in this report are designed to put competition to work for the investor, to move away from reciprocal and rebative practices, to bring transactions into the open and to focus attention where it should be—on where and how to get the best price for a buyer or seller of securities. We believe that investor confi-

dence will be strengthened as professional attention is reconcentrated on finding the best market, providing information and judgment for the investor, and getting him the best net result, unclouded by considerations relating to the rebating, the redirection and the recapturing of commissions.

The second is to adapt the securities markets to growing institutionalization, with its increased tempo and magnitude of tansactions, while maintaining the confidence and the participation of the individual investor. This will require absorbing more and larger blocks from institutions without creating spreads and price gyrations which frighten the small investor and while maintaining the depth and liquidity which has attacted investors from all over the world to our markets. That is the biggest challenge we face. We believe it can be met by bringing all offers and bids together into a single nationwide market system, by making quotations and transactions known in all parts of the country, by bringing all market-makers to a central system in which they compete under rules assuring responsibility, by giving the public an opportunity to participate in, or by protecting smaller holdings from, the discounts and premiums at which large blocks trade. This is a very difficult, technical and sensitive problem. The Commission and the staff will work closely with professionals in the securities industry to further evaluate and implement these key aspects of the central market system.

Our third emphasis is on making the professional service available to investors as efficient and economic as possible without diluting standards of service and responsibility. We all believe strongly that the market system of the future should be operated by professional brokers and market-makers dedicated primarily to serving the public in these capacities. We believe it is harmful to public confidence and to the kind of professional responsibility which should characterize our securities markets for brokerage firms to have the privilege of exchange membership without the obligation, the responsibility and primary purpose of serving a sector of the public other than their own affiliates. To this end, the Commission will use its authority as promptly as possible to eliminate the rebative and reciprocal practices specified in our report and to eliminate exchange memberships which do not clearly have a primary purpose of serving public customers. Commissioner Owens believes that these objectives require the total prohibition of all transactions by institutionally affiliated brokerage firms for their institutional affiliates. The other Commission members are not prepared to go that far at this time. All of us believe that the Congress should again review this and other conflicts of interest to weigh any deficiencies in the present method of controlling them by a combination of disclosure and fiduciary obligation against the impact of complete separation of function on the strength of the industry and its service to the public.

The Commission will act as promptly as possible to extend competition in commissions and market-making while maintaining the obligation of determining suitability in the sale of securities, encouraging the performance and broad dissemination of investment research and fostering efficiency and financial responsibility in brokerage firms. Specific steps to be taken are spelled out in our policy statement. (See page 24)

STATEMENT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE FUTURE STRUCTURE OF THE SECURITIES MARKETS

February 2, 1972

The Commission is issuing this general statement of policy at this time so that the Congress, the investing public and the securities industry fully understand the Commission's views on the present status of the securities markets and the direction in which the public interest requires that they evolve in the future.

The Commission has completed a series of hearings and special studies extending over a period of three and a half years. The latest set of hearings, which began on October 12, 1971, dealt primarily with questions related to the structure, organization and regulation of the securities markets. Earlier hearings dealt primarily with questions relating to commission rates and give-up practices. The Institutional Investor Study, submitted to Congress on March 10, 1971, accumulated extensive data on the burgeoning of financial intermediaries such as banks, mutual funds, pension funds and insurance companies, often referred to simply as institutions, and their growing impact on the securities markets. Finally, the "Study on Unsafe and Unsound Practices of Brokers and Dealers," mandated by the SIPC legislation and submitted to Congress on December 28, 1971, dealt with questions relating to the operational efficiency and financial responsibility of firms making up the broker-dealer community.

This policy statement is based on the data and testimony accumulated in this entire process of hearings and studies. It draws on the Commission's analysis of that data, as well as on the experience gained through its years of administering the securities laws.

The continued strength and vitality of the American securities markets are essential to the economic welfare of all Americans. We have the best capital market in the world. It attracts investment not only from millions upon millions of Americans and the financial institutions responsible for their savings but from investors in all corners of the world. This attraction comes from the depth and liquidity of our market, from the quality of the information and research available about our companies and from the standards of service and responsibility to investors which prevail in our investment community.

Yet disturbing problems have developed. Institutions entrusted with rapidly increasing amounts of the nation's savings have sharply increased the amount

of trading they do in the equity markets. Much of this trading is directed to markets where it is possible to rebate or redirect commissions and where the public is not aware of the prices or the volume involved. Our securities markets depend on public confidence and public participation. In our study on unsafe and unsound practices we have reported on steps taken to assure the public of the financial responsibility of those who serve investors and steps recommended to fully utilize modern technology in effectuating securities transactions.

In this policy statement we address what can be done now to assure the public that market structure is responsive to its needs. The public is entitled to disclosure of trading volume and prices in all markets. It is entitled to have competition focused on providing the best combination of price, service and transaction cost. It is entitled to regulation designed to assure fair, open and direct dealing and, to the extent feasible, to maintain price stability and market depth.

The policies set forth in this statement are designed to deal with the following specific problems which have developed in our markets:

1. With the growing institutionalization of the market, large blocks have come to account for close to 20 percent of the volume. The auction market and the specialist system have not been able to absorb this pressure without the assistance of other dealers.

2. Widespread attempts to avoid the fixed commission rate or to use commission payments as compensation for other services unrelated to the brokerage function have resulted in a dispersion of trading to the point where an investor's ability to know whether he has obtained the best execution of his order is threatened and the potential depth and liquidity of the marketplace have been impaired.

3. Reciprocal practices have proliferated to the point where they, along with restrictions on brokers' access to markets, have clouded disclosure and responsibility in the execution of orders for listed securities.

4. An increasing amount of trading in listed securities is not disclosed to the public.

The policies set forth herein are also designed to preserve and strengthen these capabilities which our markets have developed:

1. The remarkable ability of block positioners and other market-makers, including some specialists, to handle the large offerings and bids which come from the institution.

2. The network of securities firms capable of providing needed services to the public and mobilizing capital from all parts of America.

3. The high standards of fiduciary responsibility with which most securities firms serve public customers.

4. The professional investment research capabilities which have been developed to guide investor's capital on an informed basis and in the light of potential risk and reward.

In brief, these policies are designed to maintain depth and liquidity by concentrating trading in a central market system in which competing market-makers will generate the best prices, in which comprehensive disclosure will show how and where to obtain the best executions, to which all qualified broker-dealers will have access, and in which every investor can have the assurance that the professionals acting as his agents will put his interests before theirs. At the same time, we seek to move towards a structure of rules as to commissions and related matters which will eliminate gimmickry and minimize distortion and indirection in the trading of equity securities.

As things now stand, we believe that fundamental changes in trading practices, particularly the institutionalization of trading, and the nature of the prevailing commission rate structure have combined to produce fragmentation among the components of the marketplace for listed securities. Similarly, the trading of increasingly large blocks of securities has cast doubt on the ability of the marketplace to continue to provide the liquidity and price continuity which have made our markets function so well.

In evaluating alternative policies and introducing change the most critical task is the designation of objectives. In this case, our overall objective is to encourage the development of capital markets with the ability to mobilize capital effectively and in so doing to allocate resources efficiently, establish realistic and fair valuation of investments, provide necessary liquidity for securities and produce satisfactory investment services and protection for those who commit their savings to the securities markets, in whatever form. We believe these objectives can be attained by reliance on economic incentives and market mechanisms, consistent with our national policy of favoring free and open competition, except in those specific instances where the regulator's duty to protect the public dictates a limited departure from free market principles.

A CENTRAL MARKET SYSTEM

In order to maximize the depth and liquidity of our markets, so that securities can be bought and sold at reasonably continuous and stable prices, and to ensure that each investor will receive the best ossible execution of his order, regardless of where it originates, it is genera..y agreed that action must be taken to create a single central market system for listed securities. The Commission in its letter transmitting the Institutional Investor Study to Congress called for a central market system with open access by all qualified brokers and market-makers. This represented something of a shift in the historic position of the Commission, which over many years, extending from before World War II to at least the Special Study Report of 1963, tended to favor competing but separate markets. This shift resulted from technological developments which made it possible to tie markets together so that one could foster competition within a central market rather than among separate competing markets and also from the need to strengthen the existing market structure, including increased market-making capacity within the structure, in order to cope with the pressures created by the growth of institutions and

the volume of their trading. This central market system must be one which will attract and reflect all bids, offers and market-making activity in order to maintain maximum liquidity and depth.

The term "central market system" refers to a system of communications by which the various elements of the marketplace, be they exchanges or over-the-counter markets, are tied together. It also includes a set of rules governing the relationships which will prevail among market participants. To mandate the formation of a central market system is not to choose between an auction market and a dealer market. Both have an essential function and both must be put to work together and not separately in the new system.

Doing this should achieve the twin objectives of centralizing all buying and selling interest and maximizing market-making capacity. While the Commission believes it is important that a tandem central market system also evolve for unlisted securities, and recognizes that significant strides are being made in this direction through NASDAQ, this report will concern itself only with such a system for listed securities. We nonetheless note our satisfaction with the manner in which the NASDAQ communications system has been operating and intend to continue to monitor its operations and development in order to determine whether any modifications may be necessary as the evolution of a central market system progresses.

The national market in listed securities is presently divided between stock exchanges and the third market, with a relatively insignificant amount of trading occurring directly between investors without any intermediation. A central market system would internalize within that system, and make visible to the investing public, the competition which now takes place among the separate exchange markets and between all of them and the third market. The competition which now exists is not always focused on the best brokerage services obtainable but is often based as well on the ability to divert part of the commission involved in a transaction to the interests of those who initiate it and which are not necessarily the same as those of the beneficial parties involved. The trades resulting from this competition and the arrangements it spawns are not always publicly disclosed.

The central market system we look towards should be designed not only to strengthen competition but to make its operation direct and comprehensible and its results fully public. It would entail, among other things, the following elements:

1. Implementation of a nationwide disclosure or market information system to make universally available price and volume in all markets and quotations from all market makers.

2. Elimination of artificial impediments, created by exchange rules or otherwise, to dealing in the best available market.

3. Establishment of terms and conditions upon which any qualified broker-dealer can attain access to all exchanges. (Progress in this direction has already been achieved by a provision for a 40 percent discount from prescribed commission rates for brokers who are not members of the NYSE. Experimentation with this access provision may lead to further proposals for greater access.)

4. Integration of third market firms into the central market system by including them in the disclosure system (even though initially they would report principal trades on a net basis while exchange trades do not give effect to commissions) and making them subject to appropriate market responsibilities and other regulatory requirements commensurate with the benefits they may realize.

Before discussing these elements in more detail, two other matters related to development of the system are noteworthy. As the system evolves towards general access to exchange facilities it may, depending upon the nature of such access, become appropriate to provide for compensation to seat holders who invested in their seats with the reasonable expectation that such access would remain strictly limited. This could be done by means of a transaction surcharge or some form of tax relief, as the Department of Justice has suggested in its statement recently filed with the Commission. Furthermore, as the central market system evolves, changes may be desirable in the nature and function of the self-regulatory organizations. We anticipate that during the developmental stages the self-regulatory organizations will make changes appropriate to the new system. It is not necessary, however, to attempt to design at this time a self-regulatory structure for a system, the outlines of which are still not sharply defined.

A Comprehensive Disclosure System

As indicated above, an essential step toward formation of a central market system is to make information on prices, volume and quotes for all securities in all markets available to all investors, so that buyers and sellers of securities, wherever located, can make informed investment decisions and not pay more than the lowest price at which someone is willing to sell nor sell for less than the highest price a buyer is prepared to offer. Such a communications system would thus serve to link the now scattered markets for listed securities.

Actions towards establishing such a system has already been initiated by a working committee formed by the industry for this purpose. It is expected to progress rapidly, assuming that the heterogeneous components of the securities industry continue to demonstrate a homogeneous resolve. The committee has met to discuss alternative approaches and recently gave the Commission a progress report on its initial deliberations. The Commission will monitor the progress of the committee (and its expanded successor discussed below) actively to ensure that the common goal is attained as swiftly as possible.

To the extent the communications system will contain substantially real time information on quotations and completed transactions, existing rules must be broadened and reshaped to protect the public against any manipulative abuses, such as certain kinds of short selling, to which such systems may be subject. Technological means must be found to bring together promptly

transactional information from all markets and, if feasible, to present it on a single tape. Because of legibility problems, it may be desirable to develop instead a tape for very actively traded securities and to supplement it for less actively traded securities with a separate tape or a recall system which would provide data on last sale, cumulative volume and current quotes. Alternatively, a tape might be developed which would contain *all* desired information but which could be viewed on a selective, though real time, basis

In addition to developing a composite transactional tape, steps must be taken to implement a composite quotation system. The technology and hardware for such a system are said to be available, and any remaining regulatory problems should be promptly worked ou: so that the system can attain its objective of providing quotations which are truly comparable, notwithstanding the different assumptions on which they may be based.

The Commission plans to work in conjunction with the industrys' committee to take all appropriate steps to achieve the foregoing as expeditiously as practicable.

As a concrete preliminary step the Commission will promptly promulgate rules under Section 17(a) of the Exchange Act to require that by the end of each day (or more frequently if feasible) price and volume information on each listed security be collected by each stock exchange and, in the case of third market trading, be reported by broker-dealers to and be collected by the NASD, under appropriate procedures and safeguards. Such rules would provide for release of the data by the end of each day to the public news media including newspapers and, when feasible, to the composite or combined ticker or recall system and automated selective display system referred to previously. This will make it possible for investors to know aggregate trading volume and price ranges in a particular listed security in all markets in which it is traded. It is hoped that the media will cooperate with the Commission and the self-regulatory organizations to modify present reporting methods to include this additional information. In any event, this information will be made publicly available as soon as possible, and the Commission looks forward to substantial progress toward the formation of a real time comprehensive market disclosure system before the end of the year.

Rules for Competing Market-Makers

A central market system, primarily through its communications network, can maximize the opportunity for public orders to match each other and be executed in classic auction market fashion. In addition, such a system can greatly increase the depth and liquidity of the marketplace by maximizing market making capacity; that is, the ability and willingness of dealers, including specialists, market-makers and block positioning firms, to buy and sell securities for their own accounts on occasions when the other side of a public order is not readily available. This can be done by encouraging all such dealers to compete actively within the system, without any artificial restraints between component markets, to provide the necessary buying or selling power on such occasions.

It must be recognized that when market professionals are permitted to deal for their own accounts with the public, prophylactic rules are required to avoid overreaching and other abuses. Similarly, as a condition of allowing professionals the right to represent and deal with the public in the market system, these professionals should be prepared to assume certain responsibilities in respect of the liquidity and orderliness of the market.

The Commission believes that the liquidity needs of individual and institutional investors can best be provided by policies fostering the development of competition among dealers who are specialists, market-makers and block positioners. Such competition will mitigate the very difficult problem which now xists of developing and enforcing rules designed not only to prevent specialists from abusing their privileged position, but also to motivate them to perform satisfactorily under widely differing circumstances and in the light of varying risks and pressures. Nevertheless, the Commission recognizes that certain rules must be applicable to the competing specialists, third market maker and block positioning firms that will be the heart of the central market system. Such rules will be necessary for three reasons. First, not all listed securities have the trading volume and investor interest necessary to provide effective competition among market-makers (a very large proportion of listed securities trade fewer than, say, 1,000 shares a day). Second, even with the presence of competing market-makers, minimum standards are needed to assure that competition will exist in fact, not just in appearance. Third, it has long been recognized that the regulatory and self-regulatory bodies must help assure that such market-makers do not take unfair advantage of public investors.

Such rules and responsibilities can best be specified in detail by another working group formed for this purpose. This group will deal with problems such as the following:

1. How can we assure that trading by dealers is stabilizing rather than destabilizing in nature? Can this be controlled by standards more meaningful than the "tick test", including, for example, a daily net balance test?

2. To what extent, if any, should there be modifications of the existing system under which specialists are both obligated and limited to making markets in a specified group of securities, while block positioners endeavor to provide a market for almost any security in which an institutional customer has a buying or selling interest, and third market makers perform in a manner somewhere in between? To the extent that this difference in functions is preserved, what rules are appropriate in connection with each such function?

3. What standards of financial soundness should be applied to market-makers in realtion to the number and the size of the markets they maintain as well as to whether or not they carry customers' accounts?

4. Who should have access to information about limit orders and are any restrictions necessary or desirable on dealings between specialists or other market-makers and institutions? It is the Commission's present view that (*a*) competing market-makers should have access to the book (or books), although this might require that it be made public, and (*b*) the ability to deal directly with institutions contributes substantially to a market-maker's abiltiy to find demand and supply (increasing his willingness to take positions and thus improving liquidity), and the presence of competing market-makers would reduce the likelihood of the abuses which gave rise to the existing restrictions on such dealings.

General

We have not attempted at this time to decide certain questions which, in our view, can appropriately be resolved only when the central market system has evolved further. These include such matters as whether trading in listed securities should be restricted to that market system, and whether institutions should be required to limit their transactions in listed securities so that market system rather than doing business directly with each other.

Block Trading

Much concern has been expressed about the market impact of the manner in which institutions acquire and dispose of large positions in listed stocks. The ever-increasing proportion of trading in listed securities accounted for by blocks has taxed the capacity and willingness of specialists, as well as other market makers, to absorb large blocks. While the Institutional Investor Study found that on an overall basis and over extended periods of time—usually about a month—institutional trading did not lead to instability in the market, it appears that such instability does occur frequently in the short run. The impact of institutional trading in particular instances may thus be felt by the markets in general and public investors in particular through substantial fluctuations in the value of their holdings, whether as individuals or through pools of invested capital.

It is in the interest of all concerned, including investors of all sizes, corporate issuers and broker-dealers, that institutional trading not be permitted to deprive our capital markets of their basic liquidity and orderliness. A relatively small number of brokerage firms specializing in block transactions have to date performed a remarkable service in maintaining liquidity for large blocks and minimizing their impact on the public marketplace, but there can be no assurance that they will continue to do so. We have been told that lowering the level at which commission rates are subject to negotiation would deprive the block firms of some of the commission "cushion" they employ to reduce their risk of loss on blocks they temporarily take into inventory to facilitate block trades. Their ability to handle large blocks would thus be diminished, which would result in larger discounts and premiums in the movement of large blocks. Accordingly, ways must be found to ensure that these disruptions in the manner in which securities are priced in the marketplace are minimized, at least to the extent they are a result of liquidity preferences and not in response to information generally available to public investors.

A wide range of approaches has been suggested. One type of proposal is directed at decreasing the volume of block trading by imposition of limitations on the ability of institutions to change positions, or of market makers and block positioners to assist institutions to change positions, rapidly in circumstances where the market impact is likely to be severe. Another type of proposal would accept the possibility of greater price gyrations from institutions' block trading and would focus on finding ways to enable the public to participate in the block premiums or discounts. A third type of modification would recognize the fundamentally different nature of block transactions, as distinguished from normal retail auction transactions and, with the aim of avoiding retail market price fluctuations, would accord them separte treatment. For example, blocks might be crossed and reported on a tape but not interfaced with the retail auction process; that is, limit orders on the specialist's book woud not participate at all.

The foregoing proposals all raise very difficult questions and involve competing theories as to the kinds of markets that are most efficient and fair.

We would be reluctant to see any restriction on the liquidity of large blocks. Yet the cost of such liquidity may be greater price fluctuations. If greater price fluctuations, springing from the desire on the part of institutions to have instant liquidity, are to affect the value of individual holdings, directly or in pools, perhaps the public should have the opportunity to participate in resulting discounts and premiums. It also may be that requiring institutions to reflect the size of their holdings (through haircuts) in valuing their portfolios would result in a better balance between the propensity to accumulate large blocks and the expectation of instant liquidity. Better rules, procedures and incentives for positioning and redistributing large blocks may contribute to the resolution of these difficult problems.

An additional working group will be created to study and recommend rules needed to improve the handling of large blocks. Reports on the respective merits of the various approaches, and related proposals for implementation, will then receive thorough consideration by the Commission, which will consider both the problems and the suggested changes in the context of the central market system that will be evolving.

QUALITY OF SERVICE TO THE INVESTOR

Section 2 of the Securities Exchange Act of 1934 states that "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest". Just as surely the brokers and dealers who execute such transactions are so affected. They are entrusted with money and securities belonging to investors of all sizes, including those whose savings are invested indirectly through large pools of funds. It is therefore crucial that these brokers and dealers conduct their

activities in a manner consistent with the high standards imposed upon them by the Act and the needs and expectations of the investing public.

An important step toward eliminating the many discredited practices which caused concern about the ability and willingness of some members of the broker-dealer community to live up to such standards was the issuance of the Commissions' recently released study of unsafe and unsound practices, referred to above. Of equal importance are questions as to the kinds of entities which should be permitted to act as broker-dealers, the kinds of activities in which they should be permitted to engage, the manner in which charges for their services should be determined and the form which payment of such charges should take. All of these issues must be resolved so as to insure that the public can be confident of dealing with an even stronger broker-dealer community capable of reliably performing the services its customers have a right to expect for charges that are fair to all concerned.

In evaluating policy on these matters, there are several critical elements to keep in mind. One is that what is being bought and sold is a personal service—increasingly, we hope, a professional personal service. A recommendation to buy or sell a security and the execution of most orders of any size require critical elements of responsibility, judgment, skill, experience, knowledge of people and markets, information and research relating to the security. Much of the effort of the industry and the Commission over past years has been to improve the standards of responsibility and professionalism with which brokerage service is made available. Potential savings in the cost of this service are quite small in relation to the amount at stake, well under a penny on a dollar in most cases. We have observed that the cost of this service is frequently considerably lower in relation to commissions prevailing in connection with other forms of investment. We doubt that stock market commissions are significantly higher than any other investment commission, particularly when weighed in the light of the number and the complexity of the elements entering into a sound investment decision and a satisfactory execution with respect to equity securities.

This is not to say that it is not desirable that transaction costs be reduced or that it will not be possible to reduce them. We are hopeful that steps to be taken on competitive rates and on the creation of a modernized nationwide securities transfer system will result in lower transaction costs. But we would be concerned if reduced transaction costs were accomplished at the price of deterioration in standards of service and responsibility, or if apparent reductions in commissions result in higher transaction costs owing to increased spreads and fluctuations, or if investment managers made visible commission cost an exclusive criterion in deciding where to place their executions and ignored, through carelessness or fear of criticism, the elements of skill, knowledge, judgment and advice. The remaining sections of this statement set forth our views on these and related questions.

Commission Rates

The problems attributable to fixed minimum commission rates on institutional size stock exchange transactions have led to a series of modifications in the commission rate structure during the last few years. Economies of scale were first given recognition in the rate structure on December 5, 1968 when a volume discount was initiated for the portion of orders exceeding 1,000 shares. At the same time, the stock exchanges prohibited so-called customer-directed give-ups, a practice that was producing abuses which it was feared might result in challenges to the very existence of minimum commission rates. Also introduced at that time, at the instance of the New York Stock Exchange, were competitively determined rates on very large orders: members were permitted to negotiate with institutional customers in respect of the portion of the commission itself which exceeded $100,000 on a given order. More recently, on April 5, 1971, negotiated rates were introduced into the commission rate structure on the portion of orders exceeding $500,000.

Barriers to full participation in the central market must be eliminated. It should be understood that while the Commission is concerned that the level of commissions be reasonable in all transactions—and particularly in institutional transactions where the difficulties with fixed commissions are most acute—obtaining the best brokerage services, not merely the amount of the commission, must be the ultimate criterion. Our concern with the fixed minimum commission, therefore, is not only with the level of the rate structure but with its side effects as well. Of these, perhaps the most important are the following:

(a) Dispersion of trading in listed securities.
(b) Reciprocal practices of various kinds.
(c) Increasing pressure for exchange membership by institutions.

Fixed minimum commissions, at least on institutional size orders, may well make it very difficult, if not impossible, to create the central market system we envision. This is true because certain markets and market makers are very likely to choose to stay outside the system in order to compete in service charges as well as in execution, as the third market does, or in order to compete, as certain regional exchanges do, for institutional business by directly or indirectly providing institutions with rebates of commissions.

The fixed minimum commission, as pointed out below, either creates or exacerbates the problem of institutional membership. If competitive commission rates were introduced on most institutional size orders, it appears that most institutions would no longer be interested in membership, except to the extent that some would wish to engage in the general public brokerage business, which would contribute needed capital strength to the industry. We must bear in mind, however, that we are dealing with an industry which has operated under fixed commission rates for a very long time. It is necessary to measure the effect of competitively determined commissions very carefully on a step by step basis. Also, as noted above, the major thrust of broker-dealer reform should be toward upgrading standards of service to the public, including the provision of adequate information, advice, care and responsibility.

Any changes in the commission structure should not reverse this process.

The principal argument in favor if fixed minimum commissions is the severe decline in the revenue of the securities industry predicted to result if competitive rates were suddenly introduced on all institutional business. In view of the industry's recent financial crisis and the substantial scars that remain, the possibility of this occurrence is a powerful argument against any precipitous movement to competitive commissions. This would not, however, rule out moving towards competitive rates, at least on large orders, at a measured, deliberate pace. Given time and a sense of direction, the industry should be able to adjust to this change.

The Commission has cooperated with the NYSE in developing a program to monitor orders which are subject to competitively determined rates. Data received to date indicate that there have been substantial reductions in commissions on the portions of orders exceeding the $500,000 breakpoint. They also suggest that in determining the commission on the "overage" the parties take into account the overall size of the order and the amount of commission attributable to the fixed rate portion of the order.

The Commission is in the process of conducting an inquiry into the impact of competitively determined rates on the markets and market participants. While we have made no final judgment as to the breakpoint at which competitive rates should commence, we believe that at least on large institutional orders the problems engendered by fixed minimum rates can best be resolved by a process of phasing in competitively determined rates. The Commission is aware that further reductions in the breakpoint might have a more severe impact on the income of certain kinds of member firms, on the services they provide, on their role in the capital markets, including the distribution of securities, and on the desires of institutions and their managers to recapture commissions or otherwise use them for their benefit. Indeed, as will be discussed later, the Commission believes that clarification may be necessary in the concept of what services may be paid for by customers by means of commission dollars, both competitively determined and fixed.

Nevertheless, we have determined that a reduction in the breakpoint to $300,000 should take effect in April, 1972, after a year's experience with competitive rates on that portion of an order exceeding $500,000. As noted above, we have also determined to move toward the point at which commission rates on all orders of institutional size will be, at least in part, subject to competitive rates. The Commission will, of course, continue to observe the experience under the $300,000 level in considering the timing of subsequent steps.

In connection with the subject of commission rates it may be noted that any rate structure is ultimately based upon the cost characteristics of the service being paid for. As stated above, it is to be hoped, and we are optimistic, that current efforts to streamline the clearance function, especially through reduction of the movement of paper in the stock transfer process, will result in significantly lower costs. Similarly, future technological applications may make it possible to automate the execution function as well; the NYSE's experiment with automated round lot execution is an encouraging step in this direction.

Research and Suitability

There can be little doubt that the general availability of information concerning virtually every aspect of the operations and prospects of corporate issuers has been one of the most important elements which has distinguished the American capital markets from all others and which has contributed to their phenomenal growth. Further it is the process broadly referred to as "investment research" which has contributed significantly to unearthing much of this corporate information and sifting, digesting and transmitting it in meaningful form so that it may serve as the basis for market decisions by investors.

It is, therefore, the Commission's premise that broad-based securities research and its prompt and fair dissemination to large and small investors is indispensable to an efficient system of securities markets. We believe that a broker is obliged to communicate any material changes in his prior investment advice arising from subsequent research he may do to all customers whom he knows have purchased and may be holding shares on the basis of his earlier advice, at least under circumstances where to do so would not impose an unreasonable hardship on the broker.

It is also essential that, regardless of what level of competitively determined commission rates may be determined to be appropriate, the viability of the process by which research is produced and disseminated not be impaired. Presently, many institutions compensate brokers for research by allocation of commission business. If fixed minimum commissions were no longer to be applicable to institutional size transactions, an "unbundling" process might result so that some brokers would charge separate fees for services such as execution, research and the like. Nevertheless, brokers who do in-depth research might prefer to charge higher commissions than other brokers whose research activity is narrower in scope or of lesser quality or value. Concern has been voiced that under such circumstances institutional managers charged with a fiduciary duty would be reluctant to pay a higher commission rate which reflected research. The Commission believes that they should not be. In our opinion, the providing of investment research is a fundamental element of the brokerage function for which the bona fide expenditure of the beneficiary's funds is completely appropriate, whether in the form of higher commissions or outright cash payments. It should be disclosed to investors that their money manager is willing to exercise discretion in seeking the best information and research available and does not consider that there is an obligation to get the cheapest execution regardless of qualitative consideration. It should of course be expected that managers paying brokers for research with their beneficiaries' commissions or other funds would stand ready to demonstrate that such expenditures were bona fide.

Concern has also been expressed that under an unbundled rate system many small investors would seek to obtain the lowest rates available and would lose the benefit of basic research now paid for by the minimum commission. In this regard, the Commission wishes to emphasize that a broker-dealer will not be relieved of his obligation to his customer with respect to the "suitability" of a securities transaction.

It should be noted that the suitability rules are cast in terms of the needs of the customer based on information he furnishes to the broker. Unarticulated but implicit in such rules is also the broker's obligation to obtain current basic information regarding the security and then to make an evaluation as to the suitability of a recommendation for a particular customer in view of both the information concerning the security and the customer's needs.

The Commission recognizes that some customers will independently determine to purchase or sell specific securities and will not request or desire the advice of a broker and that in these circumstances it is impractical to require rigid adherence to the suitability rules. Even in such cases, however, the broker would appear to be obliged to reveal to the customer information known to him about the security which might reasonably be expected to affect the customers' decision, apart from his other duties under applicable provisions of the securities laws.

Vigorous enforcement of the standards of suitability discussed above would thus mean that as competitive commission rates are introduced the basic execution charge which would evolve would include the provision of research services to the extent necessary to comply with these standards.

Reciprocal Portfolio Brokerage for Sales of Investment Company Shares

The Commission and other persons interested in the securities industry have a number of years been seriously concerned about the widespread practice of investment company managers using portfolio brokerage of mutual funds to reward broker-dealers for sales of fund shares. This practice was examined by the Commission in its Special Study of Securities Markets (1963), its Report on the Public Policy Impilcations of Investment Company Growth (1966) and the Institutional Investor Study. Several committees of the NASD have also addressed themselves to this practice.

The regulatory problems related to the reciprocal use of portfolio brokerage, as noted in these studies, are at least fivefold. First, the practice contains the danger that the retail seller of a mutual fund will be unduly influenced to base his recommendation to his customer on the amount of additional rewards he receives in terms of portfolio brokerage commissions rather than upon the investment needs of his customers. In fact, industry leaders have found that this danger is very real in the case of other rewards that are given, over and above the ordinary fund dealer concession. They have found this to be true even where this additional source of dealer compensation is disclosed to the customer. These abuses have led the NASD to

limit or prohibit certain kinds of supplementary rewards in its Special Deals Interpretation.

Second, fund managers may be tempted to engage in various types of improper portfolio practices at the expense of fund shareholders. The competitive need to allocate portfolio brokerage commissions to fund sellers may exert pressures for frequent sales and purchases of fund portfolio securities unwarranted by sound investment considerations. Such pressures on fund managements may also result in the selection of firms to handle portfolio executions that are not necessarily in a position to obtain the best prices.

Third, the Commission's studies have reiterated the point that this form of reciprocity has serious anticompetitive impacts. The use of portfolio brokerage to reward dealers who sell investment company shares places small investment companies and complexes, which cannot allocate as much brokerage for sales as larger ones, at a distinct competitive disadvantage because the NASD's Special Deals Interpretation is not applied to reciprocal brokerage but is applied to prohibit managements from rewarding fund sellers in other ways.

Fourth, we believe that the cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not, even in part, by the existing shareholders of the fund who often derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon the existing shareholders of the fund may violate principles of fairness which are at least implict in the Investment Company Act.

Finally, the practice of compensating broker-dealers for mutual fund sales by assigning them commission business violates the long accepted precept in investment company regulation that an investor is entitled to know how much was paid to those who sell him an investment. This practice puts the investment company in the position of issuing a prospectus which purports to specify the sales compensation but fails to quantify the additional compensation paid to the customer's broker-dealer in the form of commission business awarded on the basis of success in selling investment company shares.

The Commission believes it should be made clear now that these reciprocal practices must be terminated. When the NASD completes its study of what it considers to be a fair load for the sale of investment company shares, as required by the Investment Company Amendments Act of 1970, it will be in a position to recommend a sales charge which reflects the full incentive appropriate to such sales and which can be fully and explicitly disclosed to the buyers of such shares. To accomplish this the Commission is sending a letter to the NASD setting forth the Commission's views and requesting the NASD to direct its members to discontinue the use of reciprocal portfolio brokerage for the sale of investment company shares. If such a response is not worthcoming, the Commission will then consider rule-making to accomplish the desired result.

Institutional Membership

The question of institutional membership on national securities exchanges is an exceedingly difficult one, and in dealing with it we have painstakingly reviewed the alternatives presented to us. It is the Commission's firm view that, as a central market system develops, it should have at its heart a corps of professional brokers and market makers serving investors. Moreover, in light of the strain which the magnitude and tempo of the transactions of financial institutions currently place on the securities markets, it is our view that institutions should not be permitted to deal through brokerage firms established principally to handle their own transactions but should be required to deal through brokers dedicated primarily to serving and having fiduciary obligations to a broad investing public. Thus, as a general rule, the Commission believes that membership in the central market system should be open only to those who meet qualifying standards and who have the primary purpose of serving the public as brokers or market-makers.

We should begin with definitions. The term "institutional membership" has not been clearly defined, with the result that discussion of this issue, both in terms of public policy and in terms of where responsibility for deciding the fundamental question is lodged, has been enveloped in a definitional fog. For this purpose, we define institutions to include banks, pension and other employee benefit funds, investment companies (including their advisers) and insurance companies.

There are several varieties of institutional membership. There is, first, the situation which exists on several regional exchanges in which an institution creates a subsidiary which does no brokerage business with the public, but rather exists primarily as a vehicle to obtain rebates of commissions for its parents. Such a subsidiary does not actively participate in stock exchange transactions for its parent. Rather it refers its parent's order to, or is approached by, a member of the New York Stock Exchange which is also a member of the particular regional exchange (a so-called "dual member"). The dual member executes the transaction in the primary market and then, using long established access techniques for sole members of regional exchanges, reciprocates to the subsidiary of the institution commissions on unrelated transactions. The subsidiary, in turn, rebates all or part of these sums to its parent or its affiliates.

A second situation included within the concept of institutional membership is that where an institution establishes or acquires a broker-dealer which does business for the general public and may also execute some transatcions for its parent.

There is also the situation where an existing member firm of an exchange does predominantly a public brokerage business but aslo, directly or through affiliates and subsidiaries, managers investment companies, pension and employee benefit funds and other institutional portfolios, and in connection therewith may perform brokerage functions for these managed funds and accounts.

Certain regulatory problems arise out of the relationships created by institutional membership. The first stems from the existence of a structure of fixed minimum commissions. So long as such a structure exists, large investors should not, by virtue of their economic power and size, be entitled to obtain rebates of commissions not available to other investors. While fixed minimum commissions exist, they should apply to all investors, and an exception should not be given to a particular person. Institutional membership, however, provides a vehicle for obtaining rebates, either directly or indirectly.

Second, institutional membership may result, to a greater or lesser degree depending on the circumstances, in the use of exchange membership for private purposes rather than for the purpose of serving the public in an agency capacity or otherwise performing a useful market function. In part, this problem is similar to that discussed in the preceding paragraph: the problem of using exchange membership as a means of obtaining a reduced commission rate. But the problem of using exchange facilities for private purposes is broader in scope than the rate question. For we believe that membership in the market system should be confined to firms whose primary purpose is to serve the public as brokers or market makers. Stock exchanges are affected with an overriding national interest which demands that they act to maintain and improve the public's confidence that the exchange markets are operated fairly and openly. The public should have the assurance that a member of an exchange is dedicated to serving the public, and membership by institutions not predominantly serving non-affiliated customers should not be permitted to cloud this objective.

Our authority to deal with these problems derives from the stated purposes of the Securities Exchange Act and is most specifically expressed in Section 19(b) of such Act which deals with "such matters as . . . the fixing of reasonable rates of commission, interest, listing, and other charges . . . and . . . similar matters".

Insofar as institutional membership is employed primarily as a vehicle for obtaining recapture of commissions, as in the first situation described above, it should not be allowed to exist. Membership under those circumstances is plainly in conflict with the concept of fixed minimum commissions and results in exchange membership solely for private purposes. We believe that such membership and practices which permit the rebate or recapture of commissions, directly or indirectly, should be eliminated. The Commission intends to act pomptly to terminate this type of membership. The regional exchanges, as vital elements of the central market system, should compete on their merits as market components and should not need this special competitive tool.

With respect to the second situation—where an institution establishes or acquires a broker-dealer doing business for the general public—we perceive no reason either of law or policy why this should not be permitted. The establishment of such a subsidiary doing a brokerage business for the public provides a useful source of permanent capital for the securities industry.

This necessarily implies elemination of the so-called "parent test". The question then is whether, assuming that such a subsidiary does business predominantly with public investors, it should also be allowed to execute some transactions for its parent institution as an incident to that public business.

Before discussing this aspect of the second described situation it is useful to examine the third situation—that of an existing member firm doing predominantly a public brokerage business and also engaging in money management and performing brokerage for the accounts which it manages. Such relationships have long been the practice in the securities industry, although they too can result in avoidance of the fixed commission structure for certain investors. Moreover, if it were to be concluded that it is impoper for a member firm to execute transactions for accounts which it manages, it would logically follow that it could not execute transactions for its own account (except in the performance of market functions, such as those of a specialist, block trader or arbitrageur). But it has also long been the practice in the securities industry for member firms to execute transactions for their own account. In view of the long-standing nature of these relationships and practices, we believe that a prohibition against a member firm of an exchange executing transactions, either for accounts which it manages or for its own account, would be a precipitate measure, the full consequence of which might not be foreseeable at this time. We also believe that those members of the investing public who invest directly rather than through institutions are in need of additional money management services an that the experience member firms have accumulated in the area of money management can be valuable in meeting this need. Finally, we think it important that a portion of broker-dealer income be based on a more stable source than commission business.

Returning to the second type of institutional membership, we believe that so long as member firms are permitted to transact a portion of their commission business for their own and managed accounts, it would be inappropriate to impose an absolute restriction prohibiting an affiliate of an institution from conducting any commission business on behalf of its institutional affiliate.

We should elaborate on why the Commission is unable at this time to reach the conclusion that firms affiliated with institutions should be flatly prohibited from executing transactions for those institutions. We are constrained by considerations of economic impact and of fairness as between brokerage firms created by institutions and brokerage firms which themselves have created institutions. In addition, we are mindful of the fact that Congress has had occasion to review the investment company—broker relationship and has not abolished it.

Congress in 1934 mandated a review by the Commission of whether the functions of broker and dealer should be separated, and at that time the Commission found that, on balance, it should not. Furthermore, in enacting the Investment Company Act Congress apparently did not find it necessary that the brokerage and investment company functions be completely separated. There are potential conflicts of interest in these relationships, as well as in the broker-underwiter relationship, the money manage-underwriter relationship and the dealer-money manager relationship. If all of these functions were to be separated, the capital-raising capability of the industry and its ability to serve the public could be significanty weakened. We therefore believe that the conflict of interest problem which is inherent in the combination of money management and brokerage is a matter to be resolved by Congress. Only that body should decide whether or not this potential conflict can continue to be dealt with in the same manner as the other conflicts mentioned above, by a combination of disclosure and enforcement of fiduciary obligations, or whether it is sufficiently troublesome to require separation of the two functions.

In view of these principles, we believe that all exchange members should be required to engage in a bona fide public brokerage business, except insofar as they perform a recognized market function such as that of a specialist. Precise definition of what constitutes a bona fide public brokerage business is a matter on which we will seek the advice of the self-regulatory bodies and other interested persons. We believe that concept and its definition also warrant the attention of Congress. However, it is our view that any brokerage firm which is not doing a predominant portion of its brokerage commission business for non-affiliated persons should not be considered to be conducting a public brokerage business. Predominant means to us significantly more than half. Non-affiliated persons include individual discretionary and non-discretionary accounts and the accounts of non-affiliated institutions, but do not include institutional parents or investment companies or other institutional funds which are managed under contracts or arrangements which give the brokerage firm investment discretion. The Commission will formally request the stock exchanges to adopt uniform rules restricting membeship to firms which do such a public brokerage business. If any stock exchange does not adopt such rules, we will then determine whether we should require this action or whether we should request appropriate legislation from Congress.

This qualification on institutional membership of any kind should ensure that exchange membership is utilized by broker-dealers engaged in a public brokerage business and that the opportunity to secure commission rebates is circumscribed to the greatest extent possible, consistent with minimum disruption in existing methods of doing business.

Under the system we have described, broker-dealers will remain able to diversify their business so that more stable money management income will increasingly balance off fluctuating brokerage income, and their brokerage customers will not be deprived of their money management experience. On the other hand, institutions will have an opportunity to diversify by entering the public brokerage business, thus providing needed new capital in that sector.

It is also appropriate to note concern has been expressed that direct or indirect reciprocal arrangements may be devised and utilized to avoid the

thrust of any attempt to control or regulate institutional membership. We wish to caution those considering this course that if this should occur it is our intention to adopt or require the adoption of and to enforce vigorously appropriate rules prohibiting such arrangements.

In view of the increasing internationalization of securities transactions, it is relevant to a discussion of exchange membership to consider whether brokers conducting a public business but controlled or owned by foreign entities should be permitted to become members of our exchanges. We believe that this question should be resolved in the context of reciprocal access to foreign securities exchanges, with the goal of open access under equivalent competitive conditions for all qualified brokers of all nations.

IMPLEMENTATION

To further develop and carry out the policies outlined in this statement, the following steps, among others, appear necessary:

1. The Commission will designate a working committee to continue the work of the committee constituted by the exchanges to study the development of the comprehensive market disclosure system. It is contemplated that this committee would be made up of the members of the existing committee, plus certain additional members, including Commission personnel, and that it would present to the Commission within 90 days of its formation specific recommendations on the information to be disclosed by the system and the technological means for accomplishing this disclosure, together with an analysis of the relevant economic considerations. Meanwhile, the Commission will take action to require that all exchanges and third market firms report volume and range of prices in all their transactions in listed securities on a daily basis.

2. A working committee will be appointed to study and report on the structure, regulation and governance of a central market system, including rules to regulate the activities of competing market makers and to effectively integrate the over-the-counter market in listed securities with the exchange markets.

3. A working committee will be appointed to study and propose necessary and desirable rules to ease the impact and improve the handling of large blocks.

4. Within the next 90 days the Commission will act to reduce the level at which commission rates are competitively determined down to $300,000.

5. The Commission is writing to the NASD to direct the formulation and implementation of rules terminating the practice of placing an investment company's portfolio executions with broker-dealers in consideration of their sales of that investment company's shares.

6. The Commission will promptly request all exchanges to adopt rules excluding from membership any organization whose primary function is to route orders for the purpose of rebating or recapturing commissions, directly or indirectly, in any manner or form.

7. The Commission will promptly consult with all exchanges and other interested persons in order to formulate exchange rules requiring that members engage in a brokerage business, as measured by doing a predominant part of their brokerage commission business with non-affiliated customers. These consultations will lead to a future determination as to whether implementation of this step requires Congressional action.

CONCLUSION

This Statement of Policy reflects the Commission's present evaluation of the structure and operation of the securities markets and of the industry which serves those markets. In formulating proposals to deal with the deficiencies that have been observed, the Commission recognizes that the fundamental objectives encompassed by its statutory mandate—including the protection of investors, fair dealing in securities, fair administration of the self-regulatory organizations, the prevention of fraudulent and manipulative acts and practices and the promotion of just and equitable principles of trade—may require the consideration of a broad range of regulatory alternatives for their fulfillment. As the securities markets continue to change, so must the Commission continually direct its attention to regulatory alternatives responsive to such changes.

In setting out our view of the directions in which the industry must move, we believe we have outlined the structure of a marketplace which will serve the nation well in the future. Yet we recognize that the task ahead is enormous and requires that others join us in our efforts and build upon the foundation we have sought to lay. Despite the labors which achievement of our goals will require, we can take comfort in the knowledge that if we are successful, as we believe we will be, the benefits which derive from our joint undertaking will be shared by many: the investing public, the securities industry, the financial services industry, the multitude of business enterprises with their insatiable appetite for capital and the economy as a whole.

* * *

COMMISSIONER OWENS DISSENTING IN PART:

I concur in all respects with the stand of my colleagues in the STATEMENT ON THE FUTURE STRUCTURE OF THE SECURITIES MARKETS except that I cannot agree with their conclusions regarding institutional membership and the related issues of institutional management and brokerage (page 20, et. seq.).

Before coming to the precise point of disagreement, I should like to say that under our American system of free enterprise any legally organized institution [1] should be permitted to invest in a broker-dealer subsidiary or affiliate and that that entity should be allowed entry to the exchanges, provided, of course, that it is adequately capitalized and otherwise qualified I further believe, however, and it is here that I disagree with my colleagues. that such affiliated broker-dealer should be required to do exclusively a public business and should be prohibited from engaging in any securities transactions with its parent or affiliate. The justification or rationale for such denial is that securities transactions in such a relationship permit of a rebate situation, either directly or indirectly. The granting of rebates is, of course, always damaging to the integrity of the securities industry and to the welfare of the general public which it serves: its deleterious effects cannot be cured by prohibiting exchange memberships sought primarily for the purpose of rebating or by requiring that members do a predominant part of their listed commission business with non-affiliated customers. Such restrictions, which are those advocated by my colleagues, do not prohibit rebates. They only limit the portion of the members' business which can be done on behalf of institutional affiliates and, thus, in effect, sanction limited rebates.

The Commission could implement the prohibition I advocate here pursuant to the legal authority presently vested in us by Section 19(b) of the Securities Exchange Act of 1934. That section authorizes the Commission, following certain procedures described therein, to alter or supplement the rules of a national securities exchange with respect to, among other matters, the fixing of reasonable rates of commission. Rebating is, by its very definition, a practice which impinges directly upon the effectiveness of the prescribed minimum commission rates.

Not only do I think it is bad for an institution to do business on an exchange through the medium of a broker-dealer affiliate which it controls,

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[1] For the purpose of this discussion, institutions will be defined as banks, pension and other trust funds, insurance companies and investment companies.

but on the other side of the coin, I think that the practice of a broker-dealer performing portfolio brokerage services for institutional accounts which it manages, either directly or indirectly, should likewise be prohibited. I would not include in this category individual discretionary accounts or those belonging to the broker-dealer firm itself or its principals.

The difficulty in regard to implementing this prohibition, however, is that the giving of rebates is not involved, as I see it, and we, consequently, would not have the legal authority to act administratively against this type of operation as we do in the case of the institutionally dominated broker-dealers. I would, therefore, propose that the Commission formally request the stock exchanges to adopt uniform rules prohibiting firms which manage institutional accounts from acting as brokers for those same accounts. If the stock exchanges were not willing to adopt such rules, then I would propose that the Commission petition the Congress to enact legislation to accomplish this objective.

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