



THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

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March 14, 1973


MEMORANDUM FOR JOHN EHRLICHMAN

Enclosed are the materials for our meeting with the New York Stock Exchange group tomorrow. The covering memorandum is all that you need to read at the outset. There are two major points to be covered in this meeting.

(1) A year and a half ago the two major industry trade organizations, the Association of Stock Exchange Firms and the Investment Bankers Association, merged into the Securities Industry Association under the slogan of "one industry, one voice." At this point there is a difference of opinion on some major aspects of the securities legislation, and it would be very helpful for the industry to achieve a compatibility before coming to Washington for assistance.

(2) Probably more important is the feeling that with Peter Flanigan involved in the international economic area and John Mitchell no longer in Washington, the industry has no sympathetic ear at the upper echelon of the Administration. I think George Shultz, Ken Dam and myself could handle this without too much problem.

See you in the a.m.


William E. Simon
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Enclosures



OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

MEMORANDUM

March 14, 1973

TO : The Honorable John D. Ehrlichman
Assistant to the President

FROM : William E. Simon *WES*
Deputy Secretary of the Treasury

SUBJECT: Analysis of the positions of the SEC, SIA, and NYSE on
S. 470 (Williams Bill) dealing with institutional member-
ship on the exchange, competitive commission rates and
regulation of the third market

This memorandum examines the issues raised by the subject
bill which is presently being considered by the Subcommittee on
Securities of the Committee on Banking, Housing and Urban Affairs.

1/ An issue not directly dealt with by the bill but which underlies
it is the issue of control of the central market exchange system,
if and when it is formed. The immediate issues are:

1. Whether the third market should be eliminated;
2. Whether the breakpoint for competitive commission rates
should be lowered below \$300,000 and, if so, to what extent
and within what time frame;
3. To what extent, if any, should institutional membership on
the exchange be allowed;

1/ There are presently two bills pending on this subject: S. 470
and S. 488, the Sparkman Bill. The Sparkman Bill is identical in
substance to the Williams Bill except that its provisions would not
be implemented until January 1, 1983. Accordingly, only the Williams
Bill is treated here. A comparison of the exchange membership re-
quirements in the Williams Bill, and the Sparkman Bill with SEC Rule
19b-2 is attached hereto.

4. If institutional membership is allowed, whether it should be restricted through the device of prohibiting the combining of brokerage and money management services for the same account, and, if so, to what extent.

S. 470 (Williams Bill)

S. 470 addresses each of these issues. First, it would authorize the SEC to promulgate rules preventing certain third market transactions by members for their own account or the account of a person controlling or controlled by such member "which do not yield priority parity and precedence to public orders and which do not contribute to the maintenance of a fair and orderly market." This regulates, not eliminates, the third market.

In addition, the bill would prohibit a member of an exchange from providing brokerage and money management services for the same account, whether it be its own account, the account of any affiliate of such member or any managed institutional account. This membership restriction, i.e., the 100 - 0% test, would apply to persons who were not members of any exchange on October 9, 1972, immediately upon enactment of the bill. However, the bill ties the application of this requirement to accounts managed as of October 9, 1972 date by persons who were members of an exchange on that date to the lowering of the breakpoint of competitive rates to \$100,000. For these members, the subject restriction would be phased in over a two year period beginning on the date the breakpoint for competitive rates was voluntarily reduced to \$100,000 on all exchanges. In the first year following that date, these existing members would have to meet an 80 - 20% requirement, a 90 - 10% requirement during the second year and at the beginning of the third year and thereafter, a 100 - 0% requirement.

Positions of SEC, SIA & NYSE on the Williams Bill, S. 470

The SEC, SIA and the NYSE have taken conflicting positions on the issues raised by this proposed legislation.

SEC: The SEC essentially approves the bill's provision broadening the Commission's regulatory power over third market trading. However, it would prefer that the language of this provision be redrafted to make clear that it has broad authority to regulate both on-floor and off-floor trading in a similar manner.

With respect to the issue of competitive rates, the SEC believes that the lowering of the breakpoint on competitive commission rates should be gradual in order to permit appropriate consideration of the effects of such action to insure all decisions will be rational and will accord with the regulatory objectives of the SEC. In this regard, the SEC objects to the linking of the application of the requirement of the 100 - 0% test for exchange membership with the implementation of competitive rates at a particular breakpoint, i.e., \$100,-00. The SEC believes that the issues of competitive rates and membership requirements are severable and that any legislation should reflect the necessary flexibility that will enable it to resolve both issues.

As to the question of institutional membership, the SEC feels that it is more prudent at this time to maintain the 80 - 20% requirement for membership embodied in its recently adopted Rule 19b-2, 17 C.F.R. 240.19b-2, rather than to adopt a rigid time schedule for complete segregation of brokerage and money management functions.

In addition, the SEC feels that the bill's provision for separation of brokerage and money management functions for the same account is unnecessarily sweeping in that it would apply to all managed institutional accounts, irrespective of whether the owner of such accounts are controlled by, or affiliated with, the member carrying such accounts. The SEC would limit the requirement of separation of brokerage and money management services to instances where the member is affiliated with or under control of the customer. In its view, such an approach would effectively insure that institutional money managers do not use membership for their own purposes without providing brokerage services to investors.

SIA: The SIA is opposed to any restriction of third market trading. While the SIA is not opposed to competitive commission rates in principle, it feels that further reduction of the breakpoint for competitive rates can be prudently carried out only after thorough study of the effects of competitive rates on the securities industry and securities markets. Accordingly, the SIA would object to the tying of the application of the 100 - 0% requirement for membership to the implementation of a \$100,000 breakpoint for competitive rates.

With respect to the issue of institutional membership, the SIA is in agreement with S. 470 insofar as it purports to prohibit institutional money managers from serving as brokers for their managed accounts. As to these entities, the SIA would prefer a strict application of the 100 - 0% test for membership which is not presently

provided for under current SEC Rule 19b-2, since, under that rule, transactions executed for an institutional account which an exchange member manages is treated as "public" business, provided there are no other indicia of control over the account.

However, SIA opposes the bill insofar as it would prohibit securities firms from acting as money manager and broker for the same account. SIA believes that to prohibit established brokers, currently doing a broadly based public business, from adding money management services would deny important public policy objectives, such as the promotion of competition for the management of institutional funds, the providing of combined management/brokerage service to investors and the enhancement of financial stability in the securities industry.

NYSE: The NYSE essentially supports the elimination of the third market as a step toward insuring its control over any central market system which may be established in the future. In addition, the NYSE would not be opposed to inhibiting membership on the exchanges. Consequently, it is willing to accept imposition of a system of fully competitive commission rates and the complete separation of brokerage and money management functions for the same account in order to achieve the above objectives. Lower competitive rates will of course have the effect of encouraging institutions to hire a broker's services rather than to enter the brokerage business. And strict application of a 100 - 0% membership test will operate to exclude institutional money managers from membership.

Attachment

ATTACHMENT

COMPARISON OF EXCHANGE MEMBERSHIP REQUIREMENTS IN WILLIAMS BILL, SPARKMAN BILL
WITH SEC RULE 19b-2 (AND NYSE RULES)

	<u>SEC 19b-2 and NYSE</u>	<u>WILLIAMS BILL</u>	<u>SPARKMAN BILL</u>
I Amount of business which may be done for account of			
a) Member organization	20%	0% *	0% *
b) Affiliated parties	20%	0%	0%
c) Members, Allied Members and Employees	20%	As permitted by SEC Rules*	As permitted by SEC Rules*
d) Managed Institutional Accounts	No Limit	0%	0%
e) Others	Minimum of 80% of value of exchange transactions	100% of transactions on an exchange of which is a member	100% of transactions on an exchange of which is a member
II Effective Date	March 15, 1973	October 9, 1972 for non-members as of that date and accounts after that date	January 1, 1983
III Phase-in period for Existing Members	3 years from January 16, 1973	2 years after rates negotiable above \$100,000	Until January 1, 1983
IV Exceptions			
Specialists	yes	yes	yes
Odd-lot Dealers	yes	yes	yes
Block Positioners	yes	yes	yes
Stabilizing Transactions	yes	yes	yes
Arbitrage	yes	yes	yes
Registered Traders	yes	yes	yes

	<u>SEC 19b-2 and NYSE</u>	<u>WILLIAMS BILL</u>	<u>SPARKMAN BILL</u>
Exceptions - continued			
Member off-floor trades	No *	Yes *	Yes *
Trades with prior approval of Floor official	Yes	No	No
Error Trades	Yes	No	No

* Williams Bill and Sparkman Bill both would authorize SEC to adopt rules with respect to member trading. The authority given the SEC is very broad. Presumably, the SEC would exercise this authority to limit member trading. If so, the trading done pursuant to the SEC rules would be treated as an "exception" similar to those listed for specialists, odd-lot dealers, etc.