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CHAIRMAN COHEN
COMMISSIONER WOODSIDE
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MEMORANDUM

For Commission
calendar on: date to be set.

March 3, 1966

Orval L. DuBois
Secretary

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f Trading and Markets

SUBJECT: New York Stock Exchange Rate Structure (Give-ups and Volume Discounts)

The purpose of this memorandum is to summarize the negotiations, to date, between the Commission staff and the New York Stock Exchange staff, concerning "give-ups" and volume discounts. We understand that the Exchange Committee considering such matters wishes to discuss the matter further with the Commission.

"Give-Ups"

The Exchange Position

The initial Exchange position on give-ups was set forth in the letter of November 11, 1965, from Keith Funston to the Chairman. In that letter, and in the subsequent Commission meeting with Exchange officials on November 24, 1965, the Exchange Cost and Revenue Committee explained its views on give-ups. Further meetings between the Commission and Exchange staff have clarified their position. Essentially, the initial position expressed by the Exchange Committee was as follows:

1. Member firms should not receive give-ups for services not performed in connection with the execution of an order. These would be characterized as give-aways and would be deemed improper.

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1. Member firms should not receive give-ups for services not performed in connection with the execution of an order. These would be characterized as give-aways and would be deemed improper.

2. An Exchange member could "give-up" part of its commission to another member only if the other member "did something" with respect to the order. It was the Exchange's initial view that the concept of a lead broker should be retained, i.e., one broker would receive and <u>execute</u> the entire order. That lead broker would receive <u>all</u> of the floor brokerage in connection with the order. However, at the direction of the customer it could name or "give-up" to other member firms a pro rata portion of the commissions equal to the number of shares which such other firm agreed to "clear" and perform necessary back office functions.

3. The Exchange would not restrict the category of persons who could direct the give-up or the category of members to whom the give-up was directed, so long as the recipient of the give-up did perform "the work" described in (2) above. It should be emphasized that the Exchange would insist that the entire floor brokerage be retained by the lead broker, who would execute the complete order.

4. The Exchange took the position that it was not directing its attention to the problem of excessive merchandising of mutual fund shares which arose out of give-up practices; nor was it concerned, for this purpose, with the efficiency, from a cost point of view, of members duplicating or multiplying the work which would have to be done by the lead broker in connection with the order, i.e., mailing of confirmations, receipt of certificates and funds, etc. Nor was the Exchange concerned that the give-up

represented an amount of lost income to the lead broker which was not being offset by costs borne by the recipient of the give-up; these costs, the Exchange recognized, were duplicative and did not lower the lead broker's costs.

5. Finally, the Exchange proposal was not addressed to the problem of tightening up its anti-rebate rule. Rather, the Exchange position was based on the simple proposition that members should not be compensated where they do no work and that they should be compensated if they do "some work," irrespective of whether the work performed was necessary, efficient, resulted in a reduction of expenses for the lead broker, or was related to the value of the work done.

The Commission Position

The Commission expressed its position in general terms in its letter of December 22, 1965, where it stated the following:

> "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. We think that it would be desirable to frame rules dealing with this matter in general terms and then to set forth specific criteria concerning the participation by other brokers in the execution and the commissions. These criteria could include, for example, whether the compensation received by each participating broker bears a reasonable relationship to the services actually performed by him; whether persons paying commissions to a broker are bona fide customers of such broker; whether a customer directs the method or manner of execution and sharing of the commissions and the size of the transactions.

In this connection, the best test of whether a give-up is actually compensation for services connected with a transaction, such as execution or clearance, may be whether the portion of the commission given up bears a reasonable relationship to the intra-member commission rates set out in the Exchange Constitution."

The Staff Position

The staff of the Commission has had numerous discussions with the staff of the Exchange. We have expressed the following points of view:

1. A rate structure should fairly compensate the lead broker for the services which it performs. If a particular minimum commission is set at a reasonable rate, the lead broker should retain all of the commission except for payments to others for floor brokerage or clearance if such services (a) are necessary for the completion of the transaction, (b) involve functions not performed by the lead broker and (c) involve a cost saving to the lead broker.

2. A give-up to firms who did back office work to justify receipt of a portion of the commission appeared unjustified. We took this position since the lead broker would, under the Exchange proposal, execute the entire order and would be required to mail confirmations for at least 50% of the

shares; thus any broker who did the remaining back office confirmation work would seem to be adding unnecessary and duplicative paper work. This paper work, perhaps done by four or five brokers who were not involved in the execution did, of course, involve expenditures on their part. However, the incremental costs to the lead broker for sending out a single confirmation representing the entire order and receiving all of the certificates was minimal, perhaps even nonexistent, while the additional costs to all the brokers receiving the give-up for doing the same work was substantial. We therefore took the position that while the recipient of the give-up performed a function which was costly to it, such expenditure did not appreciably reduce the expenses borne by the lead broker since the lead broker was required to do all of the floor brokerage and do the back office work for at least 50% of the shares.

3. The Exchange's initial proposal would not resolve the problem of excessive merchandising of investment company shares or potential excessive turnover of portfolio through compensating dealers by means of give-ups; rather the Exchange proposal would, if applicable to all Exchanges, limit the availability of give-ups to members of Exchanges. We therefore pointed out that not only did the Exchange proposal appear to create an inefficient rate structure in permitting unnecessary and costly rebates, but it did little to resolve the fundamental regulatory problems.

4. We also pointed out the Exchange proposal would place the Commission in a most difficult position vis-a-vis the regional exchanges since the regional exchanges would have to limit their give-ups to regional exchange members. The regional exchanges, we noted, would argue that the nonmembers of regionals were as entitled to receive give-ups for doing

nothing on an order to the same extent as a NYSE member who performed an unnecessary and inefficient function. We stated that we did not wish to put the Commission in a position of having to defend the abolition of give-ups (which would be difficult enough) in a context where the only parties who would feel the pinch would be the Regional Exchanges rather than the NYSE.

5. We also pointed out that many member firms are losing money on commission business because they are pressured to giving-up a very large portion of their commission income. The Exchange proposal would not alleviate this situation. In addition, it would create additional but unnecessary costs for the recipient of the give-up.

6. We advised the Exchange that the Commission had ample authority, and we believed would use it, to prevent a customer who was a fiduciary from inefficiently splitting-up an order, i.e., using many lead brokers in order to reward a wide variety of member firms. We stated that we did not think that fiduciaries would attempt to use a method of execution which was inefficient merely to reward persons for selling fund shares.

The Dialogue

The Exchange staff seemed receptive to the points made by the Commission staff. They pointed out, however, that there was a fundamental difference of approach. The Exchange was concerned with the problem of its members being compensated for "doing nothing." The Commission staff was concerned that the "work done" by the recipient of the give-up should be necessary, efficient and should not exacerbate the regulatory problems engendered by give-ups. The Exchange countered by noting that some of its Committee members suggested that if the Commission were concerned with excessive merchandising of fund shares or portfolio turnover, these problems would exist whether or not there were give-ups since the fund managers would merely name a lead broker to execute portfolio orders in relation to the amount of fund shares sold by him. The staff of the Commission noted, however, that this was not likely since a substantial portion of institutional orders involved the use of quite sophisticated brokerage talents prior to execution on the floor. This would necessitate a fund manager using an institutional oriented firm, most of whom do not sell investment company shares. We also noted that even if the Exchange staff was correct in believing that some brokerage business would be given to lead brokers in relationship to the business done, we could not solve all of the problems in the institutional market and would have to be satisfied with limiting the most grievous situation, i.e., the give-up.

The Exchange staff posed a series of hypothetical, but very practical situations, which both pointed up the difference in approach and which required answers. 1/

1/ It should be noted that the Exchange Cost and Revenue Committee, as well as the Exchange membership, is split on the proper approach. The Commission staff approach would tend to concentrate orders in the firms most qualified to execute orders with little give-up or give-away to other firms except to the extent that such other firms did floor brokerage or performed a clearance or correspondent function not performed by the lead broker. (This latter situation is somewhat rare since most of the major institutional firms perform these functions themselves.) The smaller Exchange member under

(Footnote continued next page)

1. Assume an investment company chooses a member firm to execute an order and wishes to reward three or four broker-dealers who have performed research (or for selling fund shares) by naming them as recipients of the give-up. Such firms would receive a give-up under the Exchange proposal if they did back office work for a pro rata portion of shares in the order. We advised the Exchange that we did not think it was feasible for a member firm to evaluate the motives for a directed give-up. Secondly, we told the Exchange that we were reluctant to recommend to the Commission a position which implicitly would recognize as appropriate the use of fund assets, i.e., commissions, for research over and above the payment for the advisory fee. Third, we stated that we could not evaluate the quality of the research, the extent to which it was required, or needed, or used (even if properly paid for by fund assets), or the extent to which it was a subterfuge for selling fund shares. Finally, we repeated our arguments set forth above that the recipient of the give-up merely did paper work; that it created an inefficient system from the overall commission rate structure and did not lower the lead broker's costs. We therefore preferred a clean break with give-ups directed by investment funds and one which was easy to enforce.

(Footnote continued from page 7)

our proposal would understandably prefer the initial Exchange approach as they would be rewarded for selling fund shares (if they send out some of the confirmations), while under the Commission staff approach, they would not be able to look to this particular source of revenue.

2. Assume a bank which supervised a wide variety of trusts for various beneficiaries has followed a general policy of acceding to the wishes of the beneficiaries in allocating brokerage. If the bank recommended the sale of General Motors and consolidated the positions of all General Motors holdings in all the trust accounts, could it use a lead broker and divide a portion of the commissions according to the individual instructions of the beneficiaries?

We advised the Exchange that it was our understanding that most banks acceded to the wishes of the trust accounts as a matter of courtesy and not contract, and that therefore it was not incumbent on the Exchange community to accept the desires of the banks. Secondly, we pointed out that some banks, Morgan Guaranty, for example, were reluctant to administer trust accounts if they lost discretion as to the choice of the broker or the method of execution. Third, we pointed out that the banks had a duty to obtain the best executions for their customers and that any system which created an incentive to go either to the NYSE or to regional exchanges based upon the kind of "give-up" which was permitted caused conflict of interest problems which were not in the public interest. Fourth, we noted that though the "excessive merchandising" aspects which were prevelent in the sale of mutual funds did not exist with respect to bank-directed portfolio orders, the Exchange should not be in a position of having to judge whether the bank was directing the give-up portion of the commission at the instruction of the beneficiary or to reward member firms for deposits or borrowing. In this latter situation, the conflict of interest whereby the bank wished to reward depositors of the bank versus its duty to go to the best market (where give-ups might not be permitted) seemed to us to be an important factor. Finally, we repeated our observation that if member firms could afford to give-up substantial portions of their income it indicated the amount of "fat" in the commission rate structure and the propriety for a volume discount.

3. An investment adviser is given instructions by the various accounts which it services to execute orders with a particular broker. Assuming that the adviser recommends the purchase or sale of a security for a number of investment accounts, should it be able to choose a lead broker for the execution and require that broker to give-up part of its commission to other firms who are members of the Exchange at the request of the beneficiary. It was the Commission staff view that if a minimum commission is to be preserved, it should not be subject to erosion at the request of customers. We stated that if a minimum commission makes sense, and if it is at an appropriate level, there should not be excess leeway to give 50% of it away where the services performed by the recipient did not lessen the expenses of the lead broker. Further, we saw no reason to distinguish the investment adviser from the mutual fund or the bank since in each of these cases the proposed give-up admitted to "fat" in the commission rate structure and created a significant amount of unnecessary costs to the Exchange community as a whole. Our staff took the same general position outlined in Nos. 1, 2 and 3 above, in regard to give-ups directed by pension trusts or corporate clients.

4. A $2.00 broker such as Truman Bidwell, receives orders to act as floor broker from many financial institutions who instruct Bidwell to clear through certain designated firms. Bidwell is not a clearing member of the Exchange and does not have back office facilities. In this case we suggested there was an economic reason or justification for the give-up of a reasonable amount since the firms receiving part of the commission would be performing a necessary function, i.e., they would be performing a service which could not be performed by Bidwell unless he significantly changed his method of operation. Thus, there was a valid business reason which could be justified from an efficiency point of view for the give-up. However, we stated that Bidwell, or others similarly situated, should limit themselves to relatively few firms for clearance and back office work since to do otherwise would give them an unfair advantage in the attraction of orders over other member firms who have their own back office and who could not attract institutional business by offering a give-up at the direction of the customer.

5. A customer wishes to purchase securities through a member other than its regular broker when such regular broker is not available. It wishes to direct a part of the commission to its regular broker. We raised no objection since the problem is de minimus, does not involve a conflict of interest, and cannot ordinarily be used by the customer in furthering inappropriate securities practices.

* * *

We explained to the Exchange that we wished their Committee to understand the staff's thinking and to report back to us if they agreed with our approach. As noted above, there is, generally speaking, a division of opinion among the Exchange members, depending upon whether they define the problem as one of conflict of interest; insuring, to the extent possible, an efficient rate structure; or as a prophylactic measure to resolve regulatory problems. Certain Exchange members take the position that they have been giving away substantial portions of their commissions for many years; that it is an accepted practice and that even though it may be inefficient, it is an accepted part of business life. We observed that the Exchange, on five occasions, has requested commission rate increases and that in connection with such requests, the Commission has examined intra-member commission rate practices; that we are now asked to consider the propriety and level of volume discounts and the extent to which the rates are reasonable; that Exchange members cannot and should not get involved in deciding what kind of give-ups involve regulatory problems or conflicts of interest; that members should not have to decide the motivation of customers who direct give-ups; that the antitrust implications of the discriminatory system of rebates through the form of give-ups has placed them in a most delicate position; that the regional exchanges cannot be discriminated against through a commission rate structure which, in effect, only permits members to reward <u>other members</u> who may be doing nothing necessary on the order -- a system which is not feasible on the regional exchanges because of their difficulty in attracting members.

The Exchange staff has told us that they explored our views with the Committee and that the Committee is prepared to discuss this matter further with the Commission.

Volume Discounts

The staff advised the Exchange that it wished the Exchange Committee to consider whether the volume discount should be based upon the execution of an order of a particular size in one day, one week, one month, or one year (the latter being in effect a class discount); whether the discount should apply only if the customer executed the order through one broker or many brokers; whether the discount should apply if a portion of the order -- perhaps a small portion -- were executed on the regional exchange and if so, might the member charge the lower commission rate on the small portion of the order executed on the regional exchange; whether the NYSE would revise its intra-member rates for floor brokerage and clearance in connection with volume discounts and, finally, whether the amount of the volume discount should approximate the amount normally given-up at the direction of its institutional investors in the existing market. We pointed out that a fair measure of the amount of the volume discount might be the approximate amount which the Committee members had suggested for the maximum amount which might be "given-up" under its present proposal, i.e., 50%. We noted that unlike the give-up which benefited the managers of portfolio investments, the volume discount would be for the benefit of the underlying customer.

The Exchange staff advised us that a volume discount was a most complex matter since to a great extent it depended upon the resolution of the give-up problem and in addition, it involved discussions or negotiations with the regional exchanges which they were not prepared to enter into because of the present antitrust climate. We were also advised that certain members have recently expressed a strong opposition to the volume discount because they contend it would reduce their commissions without attracting any additional volume. In this connection it might be noted that the volume discount initially proposed by the Exchange was criticized by institutional investors since it forced the institution to inefficiently consolidate orders in a very short period of time (one trading day on one exchange) in order to reap the benefits of the discount. This might result in a few cents saving per share on the commission paid, but in a significant dollar loss for the price of the shares, as a result of the forced block execution. We suspect that many member firms share this same view and that part of the opposition to the volume discount can be explained by the method of its proposed operation and the failure of the Exchange to design a proposal which would attract more business to it as a competitive force with the third market.

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We advised the Exchange staff that the rate structure of a major exchange could reasonably be designed to be competitive with other exchanges and with the third market; at the same time, however, it should produce the maximum benefits to the public who should derive the benefits of its flexibility; finally, the rate structure should not create regulatory problems because of byproducts and reactions to it. We suggested to the Exchange that we could assist in suggesting proper approaches to a correct balance of these three factors and that the Commission's role to some extent would have to be that of a "umpire" in protecting the Exchange, the institutional investor and the public from various economic pressures which might result in change, not necessarily in any one's best interest. We also emphasized, that if the Commission were to be involved in an overall evaluation of the rate structure, particularly as the recommendations on give-ups or volume discounts affected the regional exchanges, the Commission would have to be sure that what it was recommending for New York made good sense and was not unfair to reasonable competition. We expressed the view that the Exchange's initial proposals on volume discounts and give-ups could not be defended under this standard while we felt that the suggestions and approach offered by the staff, and in general terms by the Commission in its letter, could be defended and were quite fair to the public and to the regionals.

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