The Prudential Insurance Company of America
Newark, New Jersey

March 29, 1968

Mr. Orval L. DuBois, Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D. C. 20549

Dear Mr. DuBois:

This letter is in response to the Commission's request for comment on its proposed Rule 10b-10 and upon the New York Stock Exchange proposal which is set forth in an attachment to its Securities Exchange Act Release No. 8239.

1. The interest of the Prudential. The Prudential Insurance Company of America is significantly interested both in the proposed Rule 10b-10 and in the matters discussed in the Commission's release. This interest arises in several different but complementary ways.

First, and most important, is the Prudential's interest as a large institutional investor. As of December 31, 1967, the Prudential had more than $1.4 billion invested in common stocks. Of this amount, more than $1 billion were held as part of the Company's general funds and more than $400 million were held in a separate account designated "The Variable Contract Account." Brokerage commissions incurred during the year 1967 in connection with the purchase and sale of common stocks exceeded $2 million. In addition, it is estimated that additional commissions of more than $99 thousand would have been incurred if transactions which were effected in the over-the counter or third markets, upon which no commission as such was charged, had been effected instead upon a national securities exchange. The Prudential obviously welcomes any proposal the effect of which is to bring commission rates on securities transactions down to more appropriate levels and, more particularly, to give effect to the cost savings inherent in large volume business.

Second, the Prudential has recently established a second separate designated "The Prudential Variable Contract Account-2" (VCA-2), which has registered as an open-end management investment company under the Investment Company Act of 1940. The Prudential acts as investment manager for VCA-2 and, accordingly, it would be subject to the proposed rule. Wholly apart from the proposed rule, the Prudential is interested in minimizing the commissions that will be payable in connection with transactions on behalf of this account. While we do not believe that the Prudential's obligations in connection with the operation of VCA-2 are any different from those it has in connection with the operation of its general accounts or of its unregistered separate account referred to above, the Commission does enjoy greater regulatory authority over its activities in this respect.

Third, the Prudential is a mutual life insurance company, and as such has no stockholders. Any savings in its cost of operations, therefore, inure to the benefit of its policyholders.

Fourth, the Prudential intends very shortly to file an application for registration as a broker-dealer pursuant to Section 15 of the Securities Exchange Act of 1934 as a result of advice by the staff that the sale of certain variable contracts may not be carried on except by a registered broker or dealer. While the Prudential has joined in and supports certain proposals recently submitted to the Commission by the Life Insurance Association of America and the American Life Convention, one of which is that life insurance companies that engage in the sale of certain variable contracts should not be required to register as brokers under Section 15 of the 1934 Act, consideration of these proposals will necessarily continue over an extended period of time. In the meantime, as we explain in more detail below, the Prudential's status as a registered broker-dealer may be a significant factor affecting the impact of any rule that may be adopted by the Commission.

2. The New York Stock Exchange proposal. We note at the outset our inability to comment intelligently upon the Stock Exchange's proposal because of its complete lack of specificity. It has been evident for many years that the fixed commission rates on large volume transactions are far in excess of what is required to enable brokers who execute these transactions to make an appropriate profit. The Wharton School's Study of Mutual Funds contained elaborate data concerning give-up practices that revealed a widespread willingness on the part of executing brokers to pass on to others -- who performed no function whatever in connection with the execution of the orders -- approximately 60 per cent of their compensation. [Footnote: The retained 40 per cent, it was said, was deemed by the executing brokers to be "enough to assure the best possible service and to command the special attention required for maximum efficiency." A Study of Mutual Funds, p. 539.] The Commission's Special Study of the Securities Markets provided an even fuller account of the prevalence of reciprocal practices and sharing of brokerage commissions that could be deemed not to violate the Stock Exchange's own anti-rebating rules only by the most strained and charitable interpretations of those rules. That this matter has been the subject of both Exchange and Commission study over several years is well and publicly known.

It is disappointing, therefore, to find that all that "can now be proposed by the Exchange is that a volume discount should be incorporated "in the minimum commission schedule, the amount and nature of [which should] be subsequently determined." This much has been evident for at least five years, and institutional investors cannot take much comfort in the fact that no particularization of the proposal has been forthcoming. Indeed, the absence of particulars suggests that ground may have been lost rather than gained in the search for an acceptable solution. The Special Study plainly indicated that any volume discount should take into account not only the size of single orders but also the volume of a particular customer's business over some period of time. The release states that the Commission assumes that the discount ultimately arrived at will be both meaningful and workable. The basis for this assumption is not given, however, and investors who are currently paying what are evidently unreasonably high commissions may reasonably ask for explicit assurance that the assumption is based upon information rather than hope. Indeed, the studied absence of detail in the Stock Exchange's proposal suggests that when it is made more concrete it may be in terms of an inadequate discount on single purchases or on a single day's purchases only.

The release states that it should be possible for interested persons to express their views on the principles underlying the Exchange's proposal. We regret that we must disagree. It is not difficult to announce our support for a meaningful volume discount and that we would oppose one that is not meaningful, but this is surely already known both to the Commission and the Exchange. Moreover, the Exchange's proposals are interrelated and are expressly offered only "as a package." Until the details are known, we are incapable of making more than broad and unhelpful generalizations about the underlying principles.

We do believe that any discount to be meaningful should approximate the 60% currently being given up and must be based upon cumulative transactions on the Exchange over a period of perhaps a year. We also believe that it should not be the role of the investor to make more particularized proposals concerning the nature and extent of a volume discount than these. This, it appears to us, is the responsibility of the Exchange and, if the already unduly extended delays continue to persist, of the Commission. In view of the undoubted complexity of the subject, the desirability of having those with the greatest knowledge of the business make and justify the initial proposals is self-evident. Customers have traditionally performed the function of critics in the rate-making process, once they are aware of how a change in rates will affect them. They cannot perform this function until there is something concrete to criticize.

It can be said, however, that the proposal to support continuation of the practice of customer-directed give-ups gives credence to our belief that the volume discount proposal, when its details are known, will prove inadequate. Here, again, comment is almost impossible because of the obscurity of the proposal. Presumably, since later aspects of the proposal suggest discounts in the minimum commission schedule for "bona fide" broker-dealers, the give-up proposal would limit such payments to brokers who are similarly "qualified." These payments, again presumably, would be made to other brokers, not because they participated in executing the transaction, but because they provided some other benefit to the customer. Here, too, the absence of detail prevents useful comment because the nature of the benefit and the extent to which it is related to the functions performed by the investor may be of critical significance in determining whether continuation of the practice can be justified.

For example, payment of part of the commission to a broker solely because he has been active in the sale of mutual fund shares raises quits a different question from payment to a broker who has rendered valuable assistance to an investor and enabled him to obtain a higher return upon or greater appreciation of his funds. Investment analysis and advice may well have became so integral a part of a broker's business as to make it difficult to separate it entirely from execution of purchase and sale orders at the best possible prices and at fair commission rates. If so, the allocation of brokerage business, either directly or through commission give-up directions, to brokers who have made important contributions to the achievement of the customer's objective to invest his money wisely may not be improper or undesirable.

We are not advised, however, what limitations, if any, upon customer-directed give-ups would be imposed nor what the percentage limitation would be. [foot The release states that the Commission understands that 50 percent of the sales commission must be retained. Presumably this would be true of the lower commissions on larger or volume transactions. If so, the implication is plain that the volume discount cannot be very significant.] The Stock Exchange memorandum says only that continuation of customer-directed give-ups "would give recognition to the fact that there is more to an order than its execution." Surely it would be useful to be told precisely what is meant by this assertion, and how or whether it is to be translated into specific restrictions upon the use of give-ups. Without this information, and without the kind of discussion and analysis of the Stock Exchange proposal comparable to that contained in the narrative portion of the release with respect to the Commission's proposed rule, the impression persists that under the Stock Exchange's proposal customers will be permitted to direct give-ups without reference to the nature of the benefit they receive in return. All that we can say at this point is that we lean very strongly in favor of a commission structure that will make the excess cash available directly to the customer in the form of lower commissions rather than in the form of the privilege of deciding to whom within a certain limited class, it should be given.

Similarly, we must defer comment upon the remainder of the Stock Exchange's proposals. There is no expression of what is meant by the "qualifications to be specifically defined subsequently" of the non-members who are to be allowed a discount from the minimum commission schedule, although there is a hint in the subsequent use of the term "bona fide" that suggests the exclusion of brokers who acquire that status for the purpose of obtaining the discount. We note only that the Prudential's status as a broker-dealer will not have been acquired for that purpose but, on the contrary, will be acquired only because of the staff's insistence that we could not carry on part of our business without registering as a broker. This, it seems to us, results necessarily in the Prudential being regarded as a "bona fide broker-dealer" in any common-sense meaning of the term. But what the term might, mean under the Exchange's proposals, we have no idea.

3. The current give-up practices. Before setting forth our views on the proposed Rule 10b-10, we state briefly our position with respect to the practices described and the conclusions expressed in the Commission's release. Many of the arrangements, of course, have been the subject of considerable prior public discussion. They were described in the Special Study and are the subject published articles. Other methods of overcoming or escaping from commission schedule of the Stock Exchange, however, particularly those very recently adopted, were not known to us prior to the Commission's release. Each of these techniques, the new as well as the old, appears to share the quality of being to a greater or lesser degree unethical, underhanded, unable to be openly and unashamedly justified. It is this fact, we presume, that led the Commission, in its Mutual Fund report, to recommend the prohibition of all customer-directed give-ups.

This characterization, it must be noted, is not simply our view. It is reflected throughout the Commission's release and the attached memorandum. The methods employed are "complex." They are "obscure and often devious." They are part of an "intricate maze" involving "manufactured participations in trades" and result in compensation "by artifice." It is for this reason surprising and distressing, certainly at first blush, to be informed that a mutual fund manager, if these means are available, may be "under a fiduciary duty" to employ them to reduce the fund's commissions and that "other managers of pooled funds who act in a fiduciary capacity" may be under an identical obligation.

"[T]o say that a man is a fiduciary," Mr. Justice Frankfurter pointed out in a landmark decision involving the Commission, "only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?" "In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?" [Footnote: Securities Comm'n v. Chenery Corp., 318 U.S. 80, 85-86.] These are the last questions that require answers in the present context.

It is not the proposed Rule 10b-10 that raises these questions, since the rule provides only that if the executing broker shares his commission with another at the direction of an investment company affiliated person, the funds must go to the company. It does not say that an effort must be made to obtain such a reduction in the commission. The release, however, suggests in the strongest terms that there is a duty to make the effort.

The difficulty with this suggestion is that the nature of a fiduciary relationship is at odds with the kind of effort that seems to be required. The fiduciary concept carries with it the qualities of probity, honesty, candor and adherence to high ethical standards. Can it be the case that in pursuing the concededly high obligation to invest in the most economical fashion the money of others that has been entrusted him a fiduciary must pursue every means available to that end, however devious or dishonorable they may appear?

The practice described in the last paragraph on page 3 of the Commission's release provides a helpful particularization of the question being raised here. Institutional investors of other people's money, who therefore would be subject to this "fiduciary" duty, would presumably be aware that the New York Stock Exchange's constitution provides that commissions paid to a member shall be "...net and free from any rebate, return, discount or allowance made in any shape or manner, or by any method or arrangement, direct or indirect." They are also aware, presumably, that the Commission exercises supervisory jurisdiction over the rules of the stock exchanges relating to "...rates of commission," and that secret and discriminatory interpretation of these rules would, be unlawful. In these circumstances, would a fiduciary "be obliged to suggest to an executing broker that part of his commission be paid in cash to another designated broker who was willing to pay it over to the fiduciary in accordance with the proposed rule, and that the transaction be recorded in what must be recognized as a false bookkeeping entry? If not, does the fiduciary have a duty to accomplish the same result by devising new and more devious techniques? Must he construct an "intricate maze" that will help obscure the basic impropriety of the transaction?

The evident answers to these questions reveal the deficiency with the Commission's proposed rule, but it is a deficiency that is readily remedied. If the rule is to be adopted -- and for the reasons given below we believe it should, although only as a temporary measure -- it should be accompanied either by further rules or at least by Commission declarations that would result in the give-up and reciprocal practices being made simple rather than complex, clear rather than obscure, straightforward rather than devious, and available upon equal terms to all. Only on such a basis can a genuine fiduciary duty be erected.

In this connection, one step, at least, calls for immediate action by the Commission. It relates to membership in the National Association of Securities Dealers. Most, although not all, of the techniques described in the Commission's release, and in other published sources, are available only to brokers who are members of the NASD and not to brokers who have chosen to accept what has become known as SECO regulation. Conceivably there can be found in the 1934 Act some justification for the Commission to encourage registered brokers to become members of a national securities association. We do not believe that the Act permits the Commission to find that there is a fiduciary duty to do so. Adoption of the proposed rule, however, in the light of the Commission's discussion, might fairly be regarded as the equivalent of just such a finding. We believe that a decision whether to join the NASD -- a decision that is now under active consideration by the Prudential -- should not turn upon the fact that give-ups are more easily obtained by an NASD broker than by a SECO broker. Accordingly, we submit that whatever else may be done by the Commission, the adoption of Rule 10b-10 in the form proposed, assuming as it does continuation of present give-up practices, should be accompanied by immediate action to compel abrogation of all rules which provide NASD members with advantages with respect to give-ups that are not available to non-members.

Our other recommendations are set forth below. They are based upon the premises: (a) that the most desirable solutions to the problems discussed in the Commission's release cannot be carried out without further extensive consideration and discussion; (b) that continuation of the present practices, unabated during this interim period, would, be scandalous and cannot be justified; (c) that temporary measures, even though imperfect, are likely to be far preferable to no solutions at all, and should not be deferred because of unsupported assertions of serious or permanent injury to the brokerage community; and, finally (d) that even if errors are made, they will quickly be made known by the persons affected and can be as quickly corrected.

4. Recommendations. The Commission should move forward vigorously toward a long-term solution that will bring commission rates into an appropriate relationship with the costs of operation. This would entail requiring the New York Stock Exchange to make its proposals more specific and to explain in greater detail why it considers each of its proposals to be in the public interest. More particularly:

(1) The amount and nature of the proposed volume discount should be stated. In this connection, any failure to propose a discount that is related to the volume of each investor's transactions over a reasonably lengthy period of time, and possibly to the size of particular orders as well, should be fully explained.

(2) If customer-directed give-ups are to be continued, without regard to the purposes that are to be served thereby, an explanation of the supposed desirability of this practice should be expressly provided by the Exchange. Moreover, the percentage limitation should be set forth.

(3) It should be made clear whether give-ups, under the Exchange proposal, may be directed both to member and non-member brokers and whether any distinction is drawn between NASD members and brokers who are not NASD members; if differences are proposed between Exchange members and non-members, or NASD members and non-members, the justification should be explicitly stated.

The restrictions that the Exchange would impose upon its own members and the restrictions upon the regional exchanges desired by the Exchange should be specified; presumably if identical rules concerning give-ups are adopted by all exchanges there will no longer be any incentive to transport trades from one exchange to another solely for the purpose of enabling a commission to be shared.

(5) The qualifications of non-member brokers who will be entitled to direct discounts should be specified; presumably these discounts will be directly related to the maximum percentage permitted for give-ups.

(6) The Exchange should be required to explain in detail why the present rules prohibiting institutional membership on the exchanges should be allowed to continue and why Commission action to extend and strengthen these rules should be taken; the memorandum states only the unsupported conclusion that this is "necessary to insure the health and vitality of our securities distribution and auction market mechanisms as we know them." It may be that this is true, but surely a reasonable explanation should be required. A few institutional memberships on one of the regional exchanges appear to have been permitted before, the exchange rules were changed to prevent more widespread use of this method of reducing commission costs. This does not seem to have had an adverse effect upon the securities markets generally, although it may well have reduced the gross commissions earned by other brokers. Moreover, it is possible that the auction market mechanisms "as we know them" may not be the best of all possible worlds. As the patterns of equity investment change, and institutional investors play a greater role in the market, it is not impossible that changes in the present system might result in improvements that are in the public interest. There is surely no reason to assume that institutional exchange memberships must necessarily have evil results.

Once these proposals are made more specific, they should be published for further comment. It is possible that the Commission will find it desirable to obtain and provide investors with additional data that will illuminate the Exchange's proposals. In any event, on the basis of past experience, it is evident that a substantial period of time will be required before a satisfactory and equitable revision of the present rules and commission schedule can be accomplished. The Commission's proposed Rule 10b-10, fortunately, offers a wholly acceptable interim solution, provided it is suitably modified, or supplemented.

We urge that the Commission should promptly adopt the proposed rule. It should do so upon the understanding that it is tentative and will be modified expeditiously if experience should indicate that this is desirable. Simultaneously with the adoption of the rule, however, the Commission should take steps to eliminate the complexity and deviousness of the current give-up techniques. Ideally, this could be done by requiring the abrogation of all rules which limit the sharing of commissions only with other exchange members. If this is thought too far-reaching for an initial step, even though it be temporary, or to require procedural steps that would consume too much time, then, as a minimum, regional exchanges rules which limit allowances only to NASD member brokers should be expanded to provide equal treatment for non-member brokers. The latter proposal would, have only a limited impact upon the regional exchanges while steps were being taken toward a long-range and permanent solution.

At the same time, the Commission's release should contain a precise catalog of the various give-up techniques that have become known to the Commission. It should be stated in each case whether the use of the particular method is acceptable or whether it appears to violate some Commission policy or Exchange rule that deserves enforcement. In this way it will be learned what benefits the forces of open competition can produce without those benefits being limited to the ingenious or to persons willing to participate in questionable behavior. It may be hoped, also, that an extension of the practices currently in use, with the benefits going to the persons who are beneficially interested in the securities transactions, may provide a strong incentive for the formulation of a more direct long-range solution of the problems that have been created by the unreasonably high level of the present commission scale.

Sincerely yours,

The Prudential Insurance Company of America

By:
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