SUMMARY
OF
TRANSCRIPT OF PROCEEDINGS
IN THE MATTER OF
COMMISSION RATE STRUCTURES
OF
REGISTERED NATIONAL SECURITIES EXCHANGES

July 1, 1968 -- July 31, 1968

Office of Regulation
Division of Trading and Markets
Securities and Exchange Commission

SCHEDULE OF WITNESSES

MATTER OF COMMISSION RATE STRUCTURE OF REGISTERED NATIONAL SECURITIES EXCHANGES

1. Robert M. Bishop -- NYSE -- July 1, 1968

2. Pershing & Company -- July 2, 1968

3. Michael J. Heaney & Co. -- July 2, 1968

4. Jefferies & Co., Inc. -- July 3, 1968

5. Dominick & Dominick -- July 3, 1968

6. Reynolds & Company -- July 8, 1968

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8. Paine, Webber, Jackson & Curtis -- July 9, 1968

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10. Donaldson Lufkin & Jenrette, Inc. -- July 10, 1968

11. Cantella & Company, Inc. -- July 10, 1968

12. A. I. Jablonski & Company -- July 11, 1968

13. Harry C. Dackerman & Company, Inc. -- July 11, 1968

14. A. G. Becker & Co., Inc. -- July 15, 1968

15. Ralph W. Davis & Company (Scott Davis) -- July 15, 1968

16. Mitchum, Jones & Templeton, Inc. -- July 16, 1968

1% Stifel, Nicolaus & Company, Inc. July 16, 1968

18. H. O. Peet & Company -- July 17, 1968

19. E. F. Hutton & Company, Inc. -- July 17, 1968

20. Dishy Easton & Company -- July 18, 1968

21. Weeden & Company -- July 18, 1968

22. Delafield & Delafield -- July 19, 1968

23. Maxwell Ohlman & Company -- July 19, 1968

24. Anchor Corporation -- July 22, 1968

25. Fidelity Management & Research

26. Keystone Custodian Funds, Inc. -- July 23, 1968

2% Tsai Management & Research Corporation -- July 23, 1968

28. Elkins Wetherill -- PBW -- July 24, 1968

29. INA Trading Corporation -- July 25, 1968

30. Putnam Management Company -- July 29, 1968

31. Waddell & Reed (Kansas City Securities Corp.) -- July 30, 1968

32. American Express Company -- July 30, 1968

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NEW YORK STOCK EXCHANGE:
EXISTING MINIMUM COMMISSION RATE STRUCTURE

July 1, 1968 -- pp. 16 -- 140

Introduction

Mr. Robert M. Bishop, New York Stock Exchange Vice President and Director of the Department of Member Firms, testified concerning the operational aspects of the NYSE minimum commission rate structure, including the NYSE's past interpretations of rebative practices. Since the NYSE is the dominant exchange market, its minimum commission rate structure has proven to be the progenitor of the rate structures employed by all other exchanges, and, therefore, this testimony was intended to provide an introduction to the workings of the minimum commission rate structure in general.

NYSE Membership

A member of the NYSE is a person who owns one of the 1,366 Exchange seats (24-25). A member organization is a securities firm approved by the Board of Governors which has as a general partner or a holder of voting stock, one or more members of the Exchange (26). There are approximately 670 member organizations, many of which have more than one NYSE member. An allied member is any voting stockholder of a member corporation or a general partner in a member firm who is not a seat owner (31). Members and member organizations pay preferential commission rates; all others, including allied members, pay the full non-member commission rate.

A prospective member is investigated and interviewed by the Exchange before the purchase of the seat is approved (26). According to Mr. Bishop, the Exchange has virtually no formal requirements for membership. Mr. Bishop indicated that prospective members should, in his view, intend to spend their full time in the securities business, but he admitted that some present NYSE members do not devote their full time to the securities business(27).

Mr. Bishop was asked whether six people could band together as a member organization, finance the purchase of a seat for one of the group; the six intending to deal solely for their own accounts. The member would trade for his own account at preferential rates. The other five could place orders through the member; they would be required to pay the full non-member rate. At the end of the year, the profit derived from the allied members' own transactions could be returned to them in the form of a dividend (28-29, 33). Mr. Bishop stated at the time he could not answer the question on the facts presented (33). He then stated that he would frown on the admission of such a firm even though he knew of no constitutional prohibition (137). When asked whether a hedge fund -- which could have its own transactions executed, pay the full non-member rate, and divide the commission profits among the partners -- would be eligible for admission to membership, Mr. Bishop replied, "I will face that question when we get such an application" (138). In a letter of September 4, Mr. Bishop stated, "on reflection, I believe that Rule 318 would be a bar to the formation of such a firm. That rule requires every member organization to engage primarily in the transaction of business as a broker-dealer in securities or commodities. The hypothetical firm referred to, with all its partners trading for their own account, would probably be interpreted as not meeting the requirements of the rule."

Present Non-Member Minimum Commission Rate Structure

According to Mr. Bishop, the non-member commission rate is intended to compensate brokers for effecting securities transactions for customers, including execution and clearance of the order, and "the whole gamut of services which the broker normally gives for commissions" (67). Mr. Bishop at one point gave a partial list of allowable services: research; reasonable advertising and promotion; quotations; transmission of the order; execution and clearance; settlement; carrying the account; and custody of securities (113). Services may vary according to the customer's level of interest and investment (102). Since, however, the kinds and amounts of allowable services have never been completely spelled out, Mr. Bishop's determination of services covered by the minimum commission rate must be on an ad hoc basis (68). The minimum to be charged for execution and clearance, the mechanical aspects of a trade (see intra member rate structure, below). is approximately 21% of the total commissions. Theoretically, therefore, a maximum of 79% of the commission charged may be allocated to "services;" under the present rate structure, this 79% may be given up to other NYSE members or paid to a registered representative (139-140).

The present non-member minimum commission rate schedule was adopted in 1947; it was last modified in 1958 (38). The commission is calculated as a percentage of the monetary value of one round lot (100 shares); this amount is then multiplied by the number of round lots involved in the transaction (34). Upon being questioned about the rationale behind this structure, Mr. Bishop stated, "We are not trying to rationalize and defend this; we intend to change it" (43).

The Commission introduced four exhibits (attached) which give examples of computations of member and non-member commission rates. Outlined below are examples of commission rate charges discussed with Mr. Bishop, and his rationale for them:

(1) The commission for 100 shares of an $80 stock is approximately 2 1/2 times the commission for 100 shares of a $10 stock.

RATIONALE: The commission rate schedule was devised when the market was primarily a 100-share market. The schedule tried to strike a balance between the work involved to the broker and the value to the customer of the security traded (35). Mr. Bishop, elaborating, stated that although the work involved in trading 100 shares is the same, no matter what the value of the security, the broker gives the customer greater services "because the customer gets an equity of greater value converted to cash for him or vice-versa.. ." (36-37). Mr. Bishop analogized to percentage fees charged in the sale of houses (37).

(2) The commission for 500 shares of stock is 5 times as great as for 100 shares of the same stock.

RATIONALE: The commission rate was set when the market was primarily a 100 share market. "That is about it. You are well aware that that is not our position today" (37).

(3) For a $10 security, the percent of value of the commission paid does not fluctuate between a $1000 order and a $10 million order.

RATIONALE: Mr. Bishop's response was, "Why? No. 1947, I was not even in the securities business" (38). It was agreed, however, that this indicates there is no volume discount (39).

(4) For a trade totalling $30,000, the commission charged depends on the price of the security involved, and varies from 1.7% to 0.49% of the money involved.

RATIONALE: Mr. Bishop's response here indicated some confusion. He finally stated that as the percentage of commission increases, so do the number of shares involved, that there was a likelihood it would be more work to dispose of a greater number of shares, and that more work was entailed in clearing and delivering a larger number of stock certificates (39-41).

Mr. Bishop was given the opportunity to submit for the record written comments concerning these examples (42). In his letter of September 4, 1968 Mr. Bishop declined further comment, stating, "In reviewing the transcript, I am satisfied that I explained clearly what I believe to be the philosophy which guided the authors of the present schedule, and I do not believe it is necessary for me to add to that explanation."

<u>Present Intra-Member Minimum Commission Rate Structure</u>

Intra-member minimum commission rates are markedly lower than non-member rates (see Exhibit 4, attached). There is a rate for execution only, one for clearance only, and one covering both execution and clearance.

A. Execution

"Execution" means the actual physical trade at the trading post on the floor of the Exchange; only a member may execute a trade (43). Each order is sent to the floor of the Exchange to be executed by a member. The member who executes may be affiliated with the member organization which has sent in the order, but this is not necessarily so. If the organization's member is not on the floor, or has too many orders to handle, the order may be given to any other member acting as floor broker (44). A floor broker may be a member who executes orders primarily for his own organization and acts as floor broker only occasionally, or a member who acts as floor broker full time (44, 47). Specialists act as floor brokers when limit orders away from the market are left with them for execution; specialists derive between 40% and 60% of their income from this floor brokerage (47-48). Execution of market orders was described as follows:

Q. ... he takes a piece of paper and walks over to the post, what does he do?

A. He asks for the bid and ask.

Q. And the specialist says "50 to a quarter."

A. Yes.

Q. What does he do?

A. He decides whether he wants to act for his customer at that price.

Q. Does he have any discretion for a market order?

A. ... He has an eighth of discretion there. He would probably see what he could do the best for his customer.

Q. What would that mean? Say "fifty and an eighth," or say "I will take it at fifty and a quarter," what would he do with the slip of paper?

A. He would write down on it what he did [the] trade for and who he did the trade with and send it back.

Q. Is that essentially the function of a floor broker we have just described?

A. Yes. (45-46)

The execution commission is paid to the firm of the member who executed the trade. Mr. Bishop was asked why the execution commission for a 100 share order of a $200 stock was four times as great as that for a 100 share order of a $1 stock. He stated that one element might be that the risk involved in making errors would increase with the dollar amounts involved. This risk is not the entire dollar value of the trade, but only possible prospective market fluctuations (135). He had no response as to why commissions varied for the same dollar amounts of varying priced stocks (52-53).

B. Clearance

The clearance process is one whereby sales of securities are offset by purchases and the resulting net balances are delivered or received through a clearing house; money transfers among securities firms are also offset and settled. All trades must be cleared as well as executed, but not all firms have clearance facilities -- they clear through other firms (53-57). In clearing, a firm ensures that proper transaction recordation is made and that actual transfer and delivery of money and certificates between the parties takes place.

There are two types of clearance accounts, omnibus accounts and introduced accounts. An omnibus account is a general account for all orders of a particular correspondent securities firm. An introduced or "disclosed" account is an individual customer account carried directly by the clearing firm; in this case the correspondent firm acts as the clearing firm's agent in servicing the account (61, 63-64). For an omnibus account, the correspondent firm bills its customers directly, confirms trades to them, and is liable for customer defaults; for an introduced account these functions are carried on directly by the clearing firm (60-63).

The clearance rates in the attached exhibit are the omnibus clearance rates; clearing firms charge more for accounts kept on a disclosed basis. The omnibus rate varies with each trade, from 16.9% to 33.3% of the total non-member commission. In practice, the clearing firm bills its correspondent firm at an average rate; 21% is the minimum average execution and clearance rate allowed by the Exchange (62). Clearing firms charge a special low rate to members for members' own trades; it was explained that the rate is lower because (1) members engage in more in-and-out trading for their own account and therefore there is less to clear on balance; and (2) costly bank loans, stock loans or other services which omnibus accounts may require are not required for members' own trades (58-59).

Rebates of Commission

Article XV, Section 1 of the Exchange Constitution was read into the record. This provision states, in substance: (1) that commissions must be charged on each transaction executed by a member, whether it is on behalf of another member or a non-member; (2-) that rates charged to members and non-members may not be lower than the rates set forth in Article XV; and (3) the rates of commission, as prescribed by Article XV, must be net and free of any rebate return, discount, or allowance (19, 21-23).

A. Exchange Policing of Anti-Rebate Rule

The Department of Member Firms, headed by Mr. Bishop, is in charge of interpreting the minimum commission rate (17). Mr. Bishop has a staff of three people who spend their full time on these interpretations (18, 69). Most requests for interpretation come from member firms by phone; interpretations are given orally, and no record is made of them (69-71). Some requests are also made by letter (74). Even though many requests are repetitive, the staff has not been moved to publish any general guidelines, and a total of eight circulars dealing with rebative practices have been circulated to members since 1960 (71-75, Exhibit #10). Mr. Bishop was asked, "In view of all the repetitiveness, how come you didn't send out some circulars to members to stop the phone calls?" to which he replied, "I have no idea" (72).

Members have disagreed with the staff's interpretations, although Mr. Bishop could cite no specific instances of this (74-75). The formal procedure to be employed if a member refuses to comply with a staff order is to bring disciplinary actions before the Board of Governors or one of its committees; members may also appeal rulings to the Board of Governors (20) Mr. Bishop stated that the Board of Governors is consulted less than once a year on these matters; specifically he could recall requesting a ruling from the Board of Governors only once, in 1962 (20, 73-74). The Board of Governors has not asked the Department of Member Firms whether it considers any specific controversial give-up practices to be rebative (133).

The NYSE attitude is that since many of the problems involve the NASD and the regional exchanges as well, "they [need] the action of the SEC in order to correct them" (133). Mr. Bishop was asked how he determined whether a practice was rebative. He answered that he relied on Exchange rules and "rulings that have been made in the past, both by the staff and by the Board and its committees" (72).

In response to questioning, Mr. Bishop stated that he considered the anti-rebate provision to be very important. When asked to explain why, he answered as follows: "Well, if we were to disregard it, we would not have a minimum commission schedule. .. [I]f you have a minimum, it is a minimum that must be charged. If you permit people to give part of it back, it ceases to be a minimum" (66). Upon further questioning, Mr. Bishop stated that the minimum commission rate was designed so the customer would get only services covered by the commission and the broker would keep the commission that the minimum rate schedule requires to be charged (67).

B. Operation of Anti-Rebate Rule

As pointed out above, the portion of the minimum commission rate not allocable specifically to clearance and execution charges is to compensate the broker for an undefined spectrum of permitted services. The anti-rebate rule allows a member to share commissions with other members, and only with them. The remainder of the testimony dwelt on specific examples of these two aspects of the minimum commission rate structure. A number of the examples were taken from a memorandum prepared by the NYSE in 1965, entitled "Examples of Known Rebate Arrangements" (78-79).

Services -- General: A broker may pay the expenses incurred by a customer in placing of orders (80).

A long distance phone call billed to a member firm can be paid for by that firm, but the customer cannot be reimbursed for calls he paid for. The reason given for this distinction is that lines have to be drawn somewhere and such distinctions make policing easier (81). The general rule here is that the broker may not give cash to his customer (110).

If a representative takes a customer to dinner it would ordinarily be considered normal business entertainment, but if the representative did not accompany the customer or gave the customer theatre tickets, it would be considered a rebative practice. Normal business entertainment is defined as that permitted under the Internal Revenue Code. The rationale for allowing normal business entertainment is that it is considered business promotion and advertising and this is covered by the minimum commission (82).

A member could not prepare a customer's income tax report, but he could assist the customer in the preparation of that part concerning securities transactions. The rationale is that it is the normal function of a member firm to evaluate and arrange a customer's portfolio (83).

It is not considered a rebative practice when a son, who is a registered representative for a firm, handles his father's account and receives a full commission for that business. This would be true even if the son was doing only family business so long as the position is more than "nominal" and the account warrants a full-time representative (84-85).

<u>Services to Institutional Investors</u>: Contributions and gifts made to causes in which customers are interested with the understanding that in return more business will be given to the member is clearly a rebate. Bona fide gifts to charity are, however, allowed (89). A distinction is made between arrangements to rebate and reciprocation of business that has to be done. In the first instance a university giving a member firm large amounts of business could not request that firm to make contributions to the university. In the second situation a bank doing business with a member firm can request that the firm place its deposits with that bank. The rationale given is that the firm must deposit its money somewhere but giving contributions is not a normal business activity (90). An insurance company may request the insurance business of the firm which handles the company's portfolio (92). but a member firm cannot borrow from one bank to make a deposit in another bank which might be giving the firm business, the rationale being that the firm is incurring unnecessary expense to benefit someone giving it business (109-110).

A member firm having computers cannot let a customer use free computer time. This would be considered paying the business expenses of a non-member, prohibited by an Exchange rule. In this area of the use of computer time, some fine distinctions were made between there being no rebative practice if the member firm did the computer work, even special research for one customer, and a prohibited act if the firm allows the customer to use the computer during free time. This line is unclear (86-88).

A member firm can calculate the net asset value of a mutual fund customer twice daily. Even though this is a business expense of the non-member, it is considered within the normal services of the minimum commission rules since one service which all members provide is pricing of the customer's portfolio (86-87).

Where a member is an investment advisor to an open-end investment company, and he is executing that fund's orders, it is not considered a rebate if he reduces his advisory fee by an amount equivalent to the commission he receives. The Exchange would require the member to retain that part of the fee covering those services such as office space, etc., which are not recognized as being within the commission rate schedule (114-116).

It is not considered a rebate when a member firm purchases advertising which states that it sells a particular mutual fund even though the increased sales might increase the fund advisor's income. The member firm supposedly benefits directly from the advertisement; the benefit to the fund advisor is peripheral (106-109). Mr. Bishop stated, "Now, I don't really think that has any relationship whatsoever to any listed commission business that he might get in connection with some portfolio transaction"(108-109).

It is a rebate if a member firm sells shares of a mutual fund in return for that fund's portfolio business (93-94). "But, if you have independently come to the conclusion that this is a particular mutual fund that you would like to recommend or your customers have decided they would like to buy it for one reason or another, and if then the fund gives you some portfolio business [and] you perform in executing that portfolio business the functions normally done for the minimum commission ... I think you are entitled to the commission for it" (94).

<u>Research Services</u>: Under NYSE Rule 440A a member or member organization may, with certain reservations, furnish statistical and investment advisory services to professional non-members, other members or member organizations, or non-professional, non-member customers. This material can either originate with the member or member organization or may be prepared by others and reissued by it with the consent of the publisher. It was suggested that a rebate might be involved if an ordinary non-member customer doing $200 worth of commission business with a member firm asked for and received free research advice material prepared by another member and costing $100. There would probably be no rebate if the customer asked the member to give-up $100 of commission to the publishing member firm. Determination also seems to depend on the use to which the material will be put, i.e., if it is being given to help the customer make an investment decision it will be all right, but if it is being given to a customer who is using the material as a sales tool it will not be allowed (95-100).

It is considered a rebate if a member firm purchases research from an outside organization and provides it to a select group of customers in return for their listed business. There would be no rebate if the member firm went out and hired two researchers to supply the same information and gave that information to its non-member customers. Likewise, a member could not pay the salaries of researchers employed by a customer, but it could hire them to perform the same function (113-114). The rationale given is that a line must again be drawn and research done by the firm and its employees is permitted to be given (103-105).

<u>Services to Broker-Dealer Customers</u>: A firm may offer a non-member broker-dealer customer "[t]he same kind of service he can give to other investors for commissions" (111). The member may pay for a connecting wire between it and the non-member, theoretically the non-member must pay for any use of the wire unrelated to placing an order with that member (111-112) Training courses or sales programs for professional non-members, or Dow Jones tickers for their

offices may not be paid for by members, they are not services encompassed by the minimum commission (112-113).

Commission Sharing -- General: A public customer may direct a member firm to give up to 79% of the commission to another member firm to compensate the second member firm for research, for any other services, or for no reason at all. Not one cent of the minimum commission, however, may be given to a non-member. Mr. Bishop was asked for the rationale behind these give-ups allowed by the anti-rebate rule. "There is ... not much point in asking us to justify things that we have now decided not to try justifying" (105-106).

Mr. Bishop was asked whether commissions may be given up to compensate for the sale of mutual fund shares (119-121). He insisted that commissions "are for the execution of listed stocks" (120). and that "[t]he mutual funds have nothing to do with it" (119). "It is that the particular transaction that was executed and the commission received, the customer tells the member firm that another member firm [did] something that they consider of value in connection with that transaction and therefore, they ask them to give-up at 'wholesale' prices" (119). "[T]he dollars stay in the member firm community. After all, he gives-up some and receives some" (120).

Underwriting Give-Ups: Mr. Bishop was asked whether it was a give-up to place a non-member firm as a selected dealer in a member firm's underwriting, at the request of an insurance company which does substantial listed business with the member firm. Mr. Bishop responded, "I don't know. ..." (122).

Give-ups on Over-the-Counter Business: Whether a member may place OTC business with a non-member to return dollars from the listed business the non-member has placed with the member is a determination which the NASD, not the Exchange, must make (116-118). "We have an objection to our member firms doing anything the NASD doesn't like. As far as the commission aspect of it, I think as far as that is concerned, we wouldn't object" (117). Likewise, it is for the NASD to decide whether a member could sell OTC business net to an institutional customer (124-125).

In return for listed business, however, a firm could do OTC business at cost. In this case, "If [there] was any suspicion that it might be below cost, I think we would be justified in asking them to do a cost justification of it" (124). Mr. Bishop was asked how you determine the cost; his answer: "That is the $64 question" (123).

Mr. Bishop was asked whether a fund manager may request a member firm to place the member firm's OTC business which it does for its own customers (i.e., transactions not related to the fund's portfolio transactions) with non-members selected by the fund. Mr. Bishop stated that the practice had been brought to his attention, that he had been told it was permissible under the NASD rules, and that he raised no objection. The Department's file on this matter has been lost (120-128, 133-135).

Give-ups Via Regional Exchanges: As with NASD rules, the NYSE will not interfere with the rules of regional exchanges (125-126). Therefore, it is permissible for a member firm to execute business on a regional exchange to which it also belongs and give-up, in accordance with the rules of the regional exchange, 50% of the commission to a regional sole member for "clearance," even though the dual member has facilities for clearing its own transactions (125-126). It is also permissible for a dual member to place odd-lots and small round-lots on regional exchanges in order to give-up for crosses done on the NYSE (132). A dual member may take a cross of a dually listed stock to a regional in order to distribute commissions to non-NYSE members (129-130). A dual member can buy a block of stock on a regional in order to distribute commissions to regional members (130-131).

Mr. Bishop was asked whether a member which had both sides of a cross could, acting as principal with both buyer and seller, split the trade by buying the stock on the regional and selling it on the NYSE. Mr. Bishop stated he thought this was close to something the NYSE had ruled against. In his September 4 letter, he stated, "A review of our files and of the memories of staff members indicates that what we ruled against was not a cross but a situation in which the liquidity of the NYSE auction market was necessary to execute one side of the trade. In the situation you asked about, I do not think we would have objected because it is obvious that both sides of the cross could have been effected on a regional exchange. I might add that I know of no reason why a cross that could be executed in its entirety on a regional exchange would be split and half of it brought to the NYSE."

Mr. Bishop was asked whether an NYSE-only member could place orders for a dually-listed stock on regional exchanges, thereby rebating a full commission to a regional member. Mr. Bishop replied, "I think if it were done for the purpose of rebating, it probably would be a rebate" (129). When asked what other motivation there might be for such a trade, Mr. Bishop suggested avoidance of the New York transfer tax (129).

[four exhibit charts omitted]

PERSHING & CO.

Testimony July 2, 1968 -- p.p. 143-207

Introduction

The testimony began with a description of Pershing & Co.'s operations. The firm, in business since 1939, has a single office in New York (144). It is a member of the NYSE and the Amex but of no regional exchanges (143). Of 28 general partners, 12 are members of the NYSE, 4 are members of the Amex, 2 are in research, 3 are in the order room and the others deal with general office procedures (145).

The firm's principal business is executing and clearing trades for its correspondents. It also has institutional customers, a type of business which originally developed from its correspondent relationships. It does not solicit individual accounts and has no board room or registered representatives (144). Pershing does not underwrite and it does not make markets or position securities (162). Mr. Van Vetchen Burger testified for the firm.

Correspondent Business

Pershing has 37 correspondents, all NYSE members. It executes and clears trades for 35 of these on the NYSE and 36 on the Amex.

It will act as agent, for a small service charge, on OTC trades for its correspondents but does not clear these trades. It does not encourage this type of business, however (156).

Mr. Burger explained that the correspondents were primarily regionally based firms without New York offices. The function of Pershing is to substitute for the New York office of a large nationwide firm (145-146). Most of Pershing's business is carried in omnibus accounts, which were defined as accounts where the correspondent broker is carried as a single account, just as if he were a single customer (149). Pershing does carry a small amount of business as introduced accounts, where the account of the individual customer is carried as Pershing's own account. These are margin accounts for correspondents who do not wish to carry their own margin accounts (162-163).

Pershing provides its correspondents with various services, including execution, clearing and research. The firm's research department which consists of about 20 people, with 2 partners and 8 analysts, is concerned primarily with research for its correspondents and does little institutional type research (147-149).

Execution

Pershing has recently installed, at a cost of about $1,000,000, the most sophisticated wire system in the brokerage field (146). It goes to 180 cities throughout the country and into 210 offices. In one minute an order or message can be sent from California to the location on the Exchange floor closest to where the stock is traded (157).

The twelve Pershing members on the floor of New York are divided into 6 zones in order to better cover the Floor (157). They use $2 brokers only occasionally. About 65% of their executions are done by the firm's own floor brokers, with most of the other 35% representing orders executed by the specialist where Pershing has left limit orders with the specialist (157-158)

Mr. Burger explained the role of the Stock Clearing Corp. in facilitating comparisons of trades and the receipt and delivery of securities. He did not know what the clearing fees were but said they were minor (158-160).

The responsibility of the correspondent and of Pershing with regard to delivery and clearing was examined (149-150, 164). Mr. Burger indicated certain problems involved with deliveries, particularly where Pershing may receive only partial delivery of securities, for which it has to pay, but the bank may refuse to accept the securities until delivery is completed (182-183).

There was a brief discussion of Direct Mail Clearing, why it developed and the services it did and did not provide. The change for DMC is roughly 2-1/2% of the full commission, somewhat higher than the rate for other clearing members. Pershing estimates that taking into consideration the other costs involved in clearing by mail the total cost is about 17%. I assume this includes floor brokerage too (160-161, 162).

<u>Intra-member Charges and Correspondent Fees</u>

The minimum non-member and intra-member rates were discussed briefly. All non-members must pay the minimum non-member rate (146). Members must pay minimum floor brokerage and clearance charges if these are provided by others (150-151). While the dollar amounts and percentages vary according to the price of the security involved, the Exchanges allow a New York clearing firm for ease of administration to charge a fixed percent on all orders. However, this must be justified by the firm and approved by the Exchange as conforming to their minimum, based on computer runs of what the average rate would be on the firm's product mix (151-153).

Pershing charges all but about 5 of their correspondents 21% of the non-member commission on NYSE trades and 27% on Amex trades, the minimum rates allowed. [Footnote: Floor brokerage is higher on the Amex and there is also a lower priced product mix.] Three small firms pay slightly above 21% on NYSE trades (151-154). For the two firms where Pershing executes only it charges only Floor brokerage plus a small overage. It charges this overage because it feels that its expertise is worth more than the minimum rate in this area (153-154). The charge is 40% on its introduced accounts, where it provides additional services (163, 164).

Pershing charges the minimum 21% to most of its correspondents in order to avoid continuous pressures by correspondents for lower rates. The firm feels that if there was no minimum the rates might go lower (154). When asked how the NYSE arrived at the minimum Floor brokerage and clearance rates, Mr. Burger was indefinite (155-156).

Institutions

Pershing's rather large institutional business developed initially out of orders given to its correspondents which were sent to Pershing for execution. Eventually for ease of administration the institutions began calling Pershing directly (203). Pershing feels that at present funds and other institutions come to the firm because of its expertise in the order room and in Floor executions (204). Pershing does not block position and institutions giving it orders expect floor executions. Most orders are 1,000 and 5,000 shares (180-181). The firm has direct wires to several funds and states that there is good rapport between the trading desks of Pershing and its fund customers Mr. Burger indicated that he felt the order room, with 3 partners and 2 assistants, served a very important function in obtaining good executions (171-172)

Pershing does fund orders on two bases (167-170). The fund may call Pershing's order desk and place an order, courtesy of one of Pershing's correspondents. This is treated like an order received directly from the correspondent, and Pershing will retain 21% (25% on Amex trades) (174-175). In some cases the correspondent will conform and bill and in some cases Pershing will (175-177). Mr. Burger could not give a percentage breakdown between the two situations (176). At any rate the giveup was the same in both situations (178-179). Even where Pershing does the billing it is not considered an introduced account (191-192).

The other situation is the typical giveup by check arrangement, where Pershing executes an order and retains 25% and places the other 75% in an escrow account to be paid out later at the fund's direction (178 and Exhibit 15). The giveup may go to a correspondent or to another Exchange member (170). The order comes in to the order room just as it does with the correspondent giveup and Pershing may not know when the order is originally given what type of giveup is involved (173). They estimate that 55% of giveups are correspondent giveups and 45% are giveups by check.

Mr. Burger stated that he was unable to estimate the amount of fund and institutional business which they received over the wires from their correspondents (184). Pershing has one insurance company and several banks as customers. However, the only orders which it received directly from these customers are its own orders since there is no giveup involved (204-206).

This institutional business is relatively new and has been increasing very rapidly. However, it is also very competitive (196-197). Pershing feels that the 25% rate it receives is good, that it is getting only 21% for providing the same service for others (179). It would not be willing to do the business on a 21% basis for non-correspondents, as it feels its best rate should go to correspondents (192). On the other hand, it is getting 4% more on these giveups by check and it feels that this is worthwhile (178-181). Mr. Burger refused to speculate what would happen to their business if they gave up less but did indicate that in general, Pershing believes it competes by offering excellent service at a low cost (197). Other brokers, who provide other services to the institution, receive the rest of the commission (178-179). He suggested research might be one of these services but refused to go any further as to the purposes for which giveups are being used. He did indicate that at times Pershing was told to keep the entire commission because of a particularly good execution or for other reasons (181-182). He had earlier, in another connection, pointed out that some large orders were very difficult to handle and that large orders are not always very lucrative (179-180). However, he seemed to suggest that even on these, the giveup rate was usually the same.

When asked if Pershing would be willing to giveup to a firm such as Oppenheimer or Lehman who was a fund manager, Mr. Burger indicated that they had never done it with those firms, but that they had no restrictions on which NYSE members they were willing to giveup to (206 207).

<u>Policy</u>

Pershing is very anxious to see the correspondent giveup retained, stating that otherwise the regional firm would find itself unable to compete with the large nationwide firm (173-174). Helping their correspondents to compete with these firms was, as indicated earlier, the major interest of Pershing & Co. (202). Pershing feels that if the order had to be routed through the correspondent to Pershing the correspondent often would not get the order. On the other hand, Mr. Burger indicated that it was often because of Pershing's expertise that the correspondent was getting the courtesy order. He stated that he had no way of knowing if there was really a bona fide customer relationship between the fund and the correspondent or why the correspondent was receiving the order (202-203).

Mr. Rotberg asked Mr. Burger if he could distinguish as a policy matter between giveups to correspondents where the order was being given directly to Pershing and giveups by check. Mr. Burger's answers were nonresponsive, as he apparently did not understand the question the staff was asking (185-190). However, subsequently, in a letter to Mr. Rotberg from Mr. Burger dated July 23, 1968 Mr. Burger asked that his statement on this subject be submitted into evidence. In brief, Pershing's position is that when the giveup is to a bona fide correspondent with whom the fund has a regular brokerage relationship, it should be allowed. Such a provision would be in the public interest since it would allow the regional firm, as well as the large New York-based firm to compete for institutional business.

Exhibits

Seven exhibits were introduced during the hearing, as well as the aforementioned letter submitted subsequently. Exhibit 11 was a summary of certain figures from Pershing's I&E for 1966 and 1967. The figures brought out during the testimony (165-170) included income from omnibus accounts [1966 -- $5,884,870 (NY) plus 1,864,925 (Amex); 1967 -- $6,513,876 (NY) plus 2,073,904 (Amex)]; income from introduced accounts [1966 -- $94,791 (NY) and $17,574 (Amex); 1967 -- $117,620 (NY) and 16,039 (Amex)]; commissions from mutual funds [1966 -- $3,282,971 (NY) and $185,829 (Amex); 1967 -- $8,985,439 (NY) and $781,343 (Amex)]; giveups at direction of funds [1966 -- $2,527,888; 1967 -- $6,918,788]. The testimony is not clear as to whether the mutual fund figures include the commissions directed to correspondents. It appears that it did in 1967 but did not in 1966. (167-170, 194-195)

The remaining exhibits are samples of ledgers showing the escrow accounts (Exhibit 15) and correspondence (Exhibits 13, 14, 16, 17) dealing with giveups by check. Correspondence is between Fidelity Fund, Inc., Fidelity Management & Research, and Putnam Management Co.

MICHAEL J. HEANEY AND COMPANY

Testimony July 2, 1968 -- p.p. 208-254

Introduction

This firm was called primarily because of its high giveup ratio (it works for floor brokerage only) and because it is a small firm yet is active in the institutional field, particularly with mutual funds.

Michael J. Heaney, the witness, has been on Wall Street for 48 years, usually in the wire room. He established his own firm in 1949, and has a single office in New York. He and his son work in the office while the other two partners in the firm are Floor brokers on the Floor of the American Stock Exchange. Both seats are subordinated back to Mr. Heaney under partnership ABC clauses. In addition to the four partners, the firm has four other employees (208-210).

The firm's primary business consists of executing trades on the Floor of the Amex (209). About 30% of these executions are for other Amex brokers to whom Heaney has wires, 60% come from institutions, primarily mutual funds, and 10% come from business picked up on the Floor (216, 243-244). The firm is not a clearing member of the Amex and ordinarily does not clear trades for its customers (211).

Executing For Other Brokers

Acting as a broker's broker was Heaney and Company's original business but it has fallen off as more members put their own men on the Amex Floor. At present the firm has 10 to 12 private wires from brokers -- either members or associate members of the Amex (213). List of firms was given (214). For executing these trades, Heaney charges the minimum Amex Floor brokerage rate, which according to Mr. Heaney, runs between 9 to 14% of the non-member commission for regular members (217) and somewhat above this for associate members (222). Heaney bills these other firms at the end of each month for the commissions he has earned (220). The witness indicated that while the full commission was the same on the Amex and on the NYSE, the Floor brokerage and maybe the clearance rate, too, is a little higher on the Amex (218). In both cases, the intra-member rate structure is based on a flat-rate within certain price ranges, although it is often discussed as a percentage (219-220).

In addition to its regular brokerage relationships, the firm earns $5,000 -- $10,000 per month from Floor brokerage it picks up from others on the Floor of the Amex. This business has increased substantially in recent months (244-245).

Institutional Business

As the regular business from other brokers dropped off about ten years ago, Heaney and Company began to develop fund customers (242). Mr. Heaney listed 17 funds or fund groups with which his firm does business (221) and indicated that he had picked up 3 new funds in the last month or two (243). In addition, the firm has a longstanding relationship with Bankers Trust Company (210-211). It has a wire to the bank but presently has no wires to its fund customers (214-215).

Mr. Heaney described how an institutional order is handled once it is received in his office. Mr. Heaney personally handles the discretionary elements from the office, giving explicit instructions to his two brokers on the Floor (223-225). He feels that the firm receives business from the funds because they like the way Heaney handles orders (227-228). The firm does not sell fund shares or provide research, so that good executions are the only service it has to offer (228).

After the order is executed, the usual procedure is for Heaney 's Floor broker to give up on the Floor the name of another broker named by the fund or bank. That broker will then clear the trade and will receive the full commission, less the Floor brokerage which it must pay to Heaney for executing the trade. This amounts to a giveup by Heaney of 85-90%. Where the broker named by the fund is not a clearing member of the Amex, Heaney determines who usually clears the trades of that particular broker and gives up the name of the clearing firm on the floor, notifying the clearing firm that this is an order for its correspondent. Heaney charges the clearing firm for floor brokerage, while the remaining commission is divided between the correspondent and its clearing firms according to the contract between these two firms (225-227, 229, 232).

There are a few cases, now with only 1 or 2 funds, where the fund will ask Heaney to clear the trade as well as execute (220, 234). In these situations Heaney will collect the full commission and then give up by check to the Amex member named by the fund (236). The giveup is 50-70%, according to what the fund requests (220, 235, 239). In one case the giveup was directed to a broker who was not an Amex member; this was not permissible under exchange rules and had to be disallowed (240, 237). Mr. Heaney indicated that he had no way of knowing why giveups were being directed to a particular broker (238).

On the trades where Heaney was asked to clear, they had to use a two-step clearing operation, using both another broker who was a clearing member of the Amex and a bank. This was because the institution did not want its identity to be revealed to the clearing member (212-213, 238-239).

Mr. Heaney estimated that his firm in a recent 8 month period had received commissions of $250,000 from funds and the bank. About $160,000 represented the non-floor brokerage portion of trades where Heaney was asked to clear. The gross commissions on orders executed by Heaney for its institutional customers totaled $2-2 1/2 million.

The witness indicated that he believed that there were at least 5 to 6 $2 brokers on the NYSE who specialize in acting for funds purely on a Floor brokerage basis. He named Bidwell and Gordon in particular (240-242). He suggested that funds often found brokers like this convenient because they could often get quicker service and more flexibility than working through a large wire house (241-242).

Policy

At the end of the session, Mr. Heaney expressed his concern about whether if present giveup practices are eliminated he will be able to continue in business (243). He stated that he felt that his type of operation offered an effective way for funds to operate and if changed, might seriously affect the exchange and the funds. He feels that a lot of Amex members have no Floor brokers of their own, and somebody has to execute the trades for them and that, considering this, the fund should be able to call Heaney directly and give him an order to execute for that other member (252-253).

Mr. Heaney was asked why, if firms were coming to him because of his excellent Floor executions, they would not continue to come to him if giveups were eliminated and he had to keep the full commission. He expressed doubt as to whether he would continue to get the business under those conditions (247). Even if he did, he would have to enter into some type of clearing arrangement and this is a type of operation that he would prefer to avoid (248-251). There was also a brief discussion of direct mail clearing (253).

Exhibits

Letters from Keystone Custodian Fund and from Gemini Fund directing giveups to other brokers were submitted in evidence (234-238, Exhibits 18, 19).

JEFFERIES AND CO.

July 25, 1968 -- pp. 258-314

Introduction

Jefferies and Co. was called to testify because it exemplifies the small firm whose sole business is the execution of institutional orders and who gives up some 53% of total earned commissions at the direction of its institutional clients (267).

Jefferies and Co. was represented by Boyd L. Jefferies, President. Mr. Jefferies himself is the major shareholder, owning 65% of the stock; six others own the balance (258-259). The firm employs 35 people, 15 in a production capacity (261).

Jefferies and Co. was formed as an executing firm with a specialist operation on the Pacific Coast Stock Exchange on January 1, 1963 (259). Subsequently, the firm acquired memberships on the Detroit, Boston, P-B-W, Midwest, Cincinnati, and New York Stock exchanges (259). The firm's total capital in 1963 was $50,000 and is now $5 million (299). Jefferies does not have a research staff, does not make markets in over-the-counter securities, nor does it do any underwriting, investment banking or private placement business (263).

Jefferies is located in Los Angeles. It has floor brokers on all exchanges of which it is a member with the exception of Boston and Cincinnati (261). On Boston Jefferies executes through the firm of Cantella and Co.

Institutional Business

Jefferies specializes in the execution of institutional orders and has institutions as its main customers (including banks, insurance companies and mutual funds). It does only a limited amount of floor brokerage (259, 283-286). Jefferies has approximately 200 institutional customers with about 150 of them active (267). Approximate gross commissions from institutional customers for the last 11 months were $12 million; for the last three years they were $30 million (262). The $30 million was 70% from mutual funds; 3% from insurance companies; 17% from banks and roughly 10% from incidental customer lists (262). About 53% of this amount was given up at the direction of the institutions (267, 303). This amount however, does vary depending on the institution and the relation between it and the firm (268). Jefferies is one of the major broker doing sophisticated and complex work involving give-ups and crosses for funds in the United States (299).

Commissions Charged

Jefferies' commission for crossing blocks of unlisted securities for its institutional customers is usually a quarter of a point to each side depending on the price of the stock. On a $20.00 stock, an eighth of a point on each side is usual; on a $40000 stock, a quarter of a point. This works out per 100 shares at $25.00 for an unlisted stock as compared with $39.00 for a listed stock (265-266).

Block Positioning

While Jefferies is able to block position, i.e., buy stock for its own account when unable to find the other side, it does not generally do so (267). There was a discussion about the limited capacity of the various exchanges to absorb large blocks of stock which served to indicate the usefulness of a firm like Jefferies which can find both sides for large transactions (269).

Specialist Activities

Jefferies & Co. acts as a specialist only on the Pacific Coast Stock Exchange and only for about 38 securities, so the portion of its income derived from this activity is not significant (271). The firm does not consider its specialist activities to be helpful in returning dollars to sole members of the Pacific Exchange even though give-ups are possible on specialist trades (299A).

Give-Up Policies

The business of Jefferies and Co. is divided among the several exchanges approximately as follows: (268)

New York Stock Exchange 46%

Pacific Coast 24%

Boston 8%

PBW Stock Exchange 13%

Detroit 5%

Midwest 4%

Some 90% of the firm's trades are in dually listed stocks (271). With these securities, the preference of the customer is decisive in determining which exchange to use for a particular transaction. The customer's decision is in turn dependent upon the unique give-up policies of the individual exchange (272). Mr. Jefferies described these policies on various national securities exchanges, mentioning give-up ratios and eligibilities on the Boston (277). Detroit (276). Midwest (278). PCSE (278). and New York Stock Exchanges (276-283). If buyer and seller do not agree on which exchange to use, Mr. Jefferies admitted that he occasionally acts as principal, buying on one exchange and selling on another so as to be able to give-up in a way suitable to both customers (282). He pointed out that this is not allowed on the NYSE (280). He briefly described Jefferies & Co.'s give-ups to a foreign bank at the direction of the Fund of Funds Management Company on Detroit Stock Exchange (314).

Jefferies and Co. gives up primarily by check (274) from a reserve account into which approximately 70% of the earned commissions (or whatever amount has been agreed upon by the firm and the customer) has been placed. At the end of the month, letters of instruction usually arrive from investment company managers. Any left-over moneys are generally used up after a month or two. Reserve accounts are kept in the individual fund name, and give-ups are in turn paid in the name of specific funds rather than fund complexes.

Use of Four-Way Ticket

Although give-ups to non-members on unrelated business are not allowed on the Pacific Coast Stock Exchange, dollars can be generated to PCSE and preferred rate members at the direction of a mutual fund on unrelated trades (279). This is done by naming an unrelated firm as the clearing member on trades executed by Jefferies for other customers or for his trades as principal. The clearing member can then charge a maximum of 50% of the normal stock exchange commission for clearing that order (279). This whole procedure of generating dollars is done by an entry on the books of the Stock Clearing Corporation and entails the use of what is called the four-way ticket (289, 292-192). The four names, buyer, seller, who will deliver the certificates, and who will receive them, are supplied to the Stock Clearing Corporation by the executing broker on the floor (293). The discussion of clearing charges and the discussion of the responsibilities of clearing firms which followed included an outline of the arrangements of Jefferies and Co. with IDS and IDSS, and with Kansas City Securities Corp., Waddell-Reed, Inc., and United Funds (292-298). Jefferies and Co. itself receives few give-up checks, but when it does they are usually related to IDS and are then passed on to IDS Securities Corp. through unrelated business on the PCSE (307).

Give-up Technique

This testimony served primarily to show that rules of the exchanges which limit the percentage of the give-ups can be circumvented simply by bringing in more unrelated trades and giving-up in those trades until the total dollar arrangement is satisfied (299).

Floor Brokerage Activities

Another function which Jefferies and Co, performs for certain funds is called "executing trades" (283). In these cases, the trades (usually crosses arranged and executed by Jefferies) are cleared by an unrelated firm, and Jefferies receives only 10% (or $1,000 floor brokerage out of a total commission of $10,000) (285). The remaining 90% (or $9,000) of the total goes to the clearing firm (90% and up) (285). Jefferies does this despite the fact that it could itself have cleared the trade at a maximum cost of $250.00 (283-286). These floor brokerage commissions amount to between 10-20% of Jefferies' total annual gross commissions.

When questioned about his willingness to give-up such substantial portions of commissions earned, Mr. Jefferies answered that his firm was small with relatively small overhead, and therefore, was able to operate on a small profit margin (299).

Membership on NYSE

Jefferies & Co. joined the NYSE in 1967 in order to complement the business it was doing on the regional exchanges and to be able to execute in the primary market as well as in secondary markets (310). When Jefferies does use the primary market, it uses its own floor broker to execute, obtains full commission, and then gives-up only in accordance with the rules of the New York Stock Exchange (310). Before it joined the NYSE, Jefferies received back some of the commissions paid to a New York member for execution via for four-way ticket on the Pacific Coast Stock Exchange (311). Jefferies cleared for unrelated trades on the Pacific Coast Stock Exchange, and received some floor brokerage from New York member firms to make up for what Jefferies had paid out for executions on the NYSE (312).

Mr. Jefferies did not believe that its New York Exchange membership had affected the number of trades flowing to the Pacific Coast Stock Exchange in order to reciprocate Jefferies for business (312). He believes that 80% of the time, the exchanges' auction markets are not involved in his business (313).

Exhibits

Exhibit #20 is an example of a four-way ticket. Exhibit #21 lists commissions received from and given up for the top twenty fund customers. Exhibit #22 is a financial statement showing the amount of commissions earned from funds and given up for the month of February, 1968.

DOMINICK & DOMINICK, INC.
Testimony July 3, 1968 -- p.p. 315-397

Introduction

Dominick & Dominick is a member of the New York, American, Midwest, Pacific Coast and Boston Stock Exchanges and has trading rights on the PBW through its membership on the Boston Exchange (316-317).

Dominick has 30 branch offices in the U.S. and 5 abroad including three Canadian ones. It has 381 registered representatives, 210 of which are compensated on a commission basis. On the whole the firm employs 1,151 people in the U.S. and 26 in foreign countries (318-319).

Dominick has 3 Floor brokers on the New York Stock Exchange and 2 on the American Stock Exchange. It also has Floor brokers on the Boston Stock Exchange, whose principal activity is that of a specialist (319).

Dominick also acts as a broker's broker and has correspondent firms. It clears for 17 member firms on the NYSE, 11 of whom maintain omnibus accounts as out-of-town correspondents (319, 338-339).

In addition to execution and clearance, the firm offers a large number of services including block positioning and research. The broad research effort includes computer programs for industrial stocks, common stock surveys, utility stock studies, and economic analyses for the funds (387).

In calendar 1967 the gross income of Dominick was approximately $34 million, with 72% coming from brokerage commissions, 11% from underwriting, 9% from trading profits, and the remainder from miscellaneous sources (317). The breakdown of sources of Dominick's commission income in 1967 shows 35% coming from mutual funds, 15% from correspondents and 50% from retail brokerage, including that for banks, pension funds and insurance companies (320). Of its commission income in 1967, Dominick earned 77% on NYSE; 14% on Amex; 1.1% on PCSE; 1.6% on Midwest; 1.3% on Boston and 5% from over-the-counter trading (321).

<u>Mutual Fund Business</u>

Dominick uses the term "institutional business" to refer only to mutual fund business (322). In recent years both the size of these fund orders and the percentage of gross commissions earned by Dominick from fund transactions have increased substantially (322 and 323).

The average size of a fund or "institutional order" received by Dominick is 9,000 to 10,000 shares; however, the average size of fund transactions is only 4,000 shares (322, 367-368).

Included is a discussion of the funds' manner of placing orders and of Dominick's manner of handling them through its special service department located at the Wall Street office; Dominick's method of compensating its sales people; as well as the mechanical aspects of finding both sides to a cross, block positioning, getting blocks to a market whether an exchange or the third market, and negotiating a price (323-333).

Dominick stated that its reason for joining the various regional exchanges of which it is a member was to insure its capability of handling orders for local customers who requested that an order be effected on the local exchange (334). Problems in executing orders on the regionals relating to the size of the orders were also mentioned (335).

Dominick's reasons for taking orders to the regionals were that a better price existed and, more commonly, that a customer had directed them to do so. A study in May of 1968 showed that of Dominick's total transactions 9% were executed on the regionals, 5% in the over-the-counter market, and 86% on the New York exchanges (340-343).

<u>Give Ups and Commission Charges</u>

The majority of orders received from fund managers are accompanied by a request to give up part of the commission earned (345). Arrangements as to the amounts of the give-ups vary depending largely upon the volume of business anticipated from that fund (348). In calendar 1967, Dominick gave up about 42% of its gross mutual fund commissions (344-345). The commission charged for finding the other side to a cross depends largely on the risk involved. Commission charges also vary between listed and unlisted securities (348-352).

<u>Give-up Methods</u>

Most give ups from Dominick are by check. Dominick gives up approximately 40% or $2 million of its gross commissions at the direction of fund managers (353). If Dominick gives up by naming another broker-dealer as the clearing member it does not give up over 60% (354, 353). Although Dominick in recent years employed the 4-way ticket, the firm no longer finds this necessary because it now takes more crosses to the PCSE and thereby gives up to Kansas City Securities, IDS and Channing (355, 384-385). Dominick gives up at the direction of insurance companies where large transactions are involved (357).

Dominick states that it had not given up at the request of an individual although it had been asked (394-395); that it had not been requested by a fund manager or bank to give-up part of its over-the-counter commissions on unrelated transactions, nor had it done so; and that it had never been requested to give-up to an NASD dealer part of any fees earned in soliciting tender offers (396).

Amount of Give-Ups

Dominick gives up the same percentage of the commissions earned regardless of the size of the order (369). The bookkeeping costs are the same. Further explanation appeared on pp. 369-371. Dominick pointed out that (1) they do not execute orders for people they do not know and (2) they do not give-up without having negotiations as to the rate of the give-up based on anticipated volume (371). Dominick, as an institutional block firm, begins the negotiations on give-up percentages in the area of 50% (372-373).

When asked to read into the record the list of its twelve largest fund customers and their give-up percentages, Dominick declined, citing competitive reasons. Noting that the document was produced under subpoena, the hearing examiner ruled that the staff's request was proper (373-377). This list became Commission Exhibit #27 (377). Exhibit #26, a table entitled Dominick & Dominick Total Mutual Fund Business for May 1968 was also introduced (377).

In the discussion which followed, emphasis was laid on the varying amounts (from 6% to 65%) paid out at the discretion of the different funds (377-381). Give-up arrangements with IDS (naming Sheffmeyer as clearing broker) (381) and United Funds by sending money to Kansas City Securities for trades done on the Pacific Coast and Boston Stock Exchanges and by executing United Fund trades on the Pacific Coast and Boston Stock Exchanges were explained (382). Dominick has not given up at the direction of United Funds to any members of the New York Stock Exchange in 1968. Instead, the firm has tried to get commission business back to Kansas City Securities by frequent use of their brokers on the Pacific Coast (384). So far in 1968 Dominick is approximately doubling its use of the Pacific Coast Stock Exchange.

When asked why give-ups were directed to particular broker-dealers, Dominick agreed that it was often compensation for having sold shares of that fund manager's funds (385). Dominick has itself received give-ups in the past both for sale of mutual funds and for its research effort. For example, in a slow period with little business to give out, the fund manager could do a trade with another firm and then compensate Dominick for its research efforts by directing give-ups to it (386-387).

Policy

The remainder of the testimony was directed to a discussion of negotiated rates and, specifically, whether current practices were not the equivalent of negotiated rates (387-393). Dominick pointed out that as a matter of practice, the rates are not negotiated with each individual trade (388). It was pointed out, however, that there are occasions when the give-up on a particular trade differs from the basic give-up rate agreed to by Dominick and the institution (389-390).

Exhibits

Letters containing give-up instructions from various funds, investment advisers and banks were introduced as Exhibit #23. A sample schedule of reserve accounts for 4 months of 1968 was introduced as Exhibit #24 (361). Commission Exhibit #25 was a letter from National Securities Research Corp. which directed Dominick to name 16 NASD dealers to the selling group of an issue underwritten by Dominick for the sole purpose of receiving give-up money. Dominick emphasized that this was a unique experience (362-365). Exhibit #26 is a table showing Dominick's total mutual fund business for May 1968. Exhibit #27 is a list of gross commissions and give-ups for the year 1967 and the first 4 months of 1968.

Reynolds & Co.
July 8, 1968 pp. 401-501

Introduction

Reynolds & Co. is a major brokerage firm in the general securities business (402). Robert Gardiner, managing partner of Reynolds and Company in New York, was the primary witness. The firm has 50 branch offices throughout the country and employs 807 account executives (408-409). The firm is a member of most exchanges, but it has floor brokers on only the American and New York floors. In 1966 Reynolds earned approximately $39 million in securities commission income, of which 65.5% was earned on the NYSE, 19.5% on the Amex, 10.1% in the over-the-counter, and 4.9% on the regional exchanges (403-404). In addition to its securities commission business, the firm sells mutual fund shares, participates actively in the corporate underwriting field, is active in the municipal bond field, and derives interest income from customer accounts (406-408). The firm also handles executions for approximately 20 correspondents (417-419).

Description of Institutional Accounts

Reynold's institutional clients include investment companies, banks, insurance companies, pension funds, and large individual accounts. About 10% of the firm's commission business is institutional business. The sources of commission income from institutions is as follows: 59% from investment companies, 18% from the banks and trusts, 13% from other institutions, and 10% from individuals whose accounts are sufficiently large that they can qualify as institutional accounts (413). Of 101,745 active firm accounts, 3,043 are institutional accounts (408). The investment companies are house accounts, while the balance of institutional accounts are assigned to individual representatives (414). There is some discussion in the transcript as to the solicitation of institutional orders and the handling of those orders (414-416).

Breakdown of Investment Company Commission Income

Exhibit #28 shows commissions from investment companies in 1967. Reynolds earned $2.3 million from investment companies in direct brokerage. It also received $410,000 in give-up checks from primarily NYSE member firms for transactions effected on the NYSE (422-435). Reynolds paid out about $823,000 in give-ups to broker-dealers designated by Reynolds' institutional customers (426-427). Reynolds allocated $139,000 of the amounts received, as a matter of internal bookkeeping, to pay for research it provided its institutional customers (429-431). After having taken into account give-ups and research expenses, the firm is left with a net of $1.7 million, which it has labeled "Net Service Commissions," and which represents Reynolds' earnings "through serving these investment companies in all capacities" (432).

If give-ups received ($410,000) are subtracted from give-ups paid ($823,000). the net give-up figure is $413,000, approximately 19% of gross commissions received. Reynolds, however, objects to subtracting give-ups received from give-ups paid; it considers its net give-up percentage is 35% ($823,000/$2.3 million). To Reynolds, the $410,000 in give-ups received is a separate figure representing research or some other service actually performed to earn this money. These services include selling shares in client's funds (434-435).

Comparison of Fund Sales and Fund Commission Income

The firm introduced exhibit #29 entitled "1967 Mutual Fund Sales" (435). The 20 fund complexes on the list accounted for 94% of the firm's total mutual fund sales in 1967. Exhibit #30 entitled "1967 Mutual Fund Commission Production" was presented to show the 20 fund complexes which represented about 96% of the firm's total mutual fund commission production in 1967 (436, 437). Each of the fund complexes for which the firm had done the most selling -- with perhaps one exception -- listed on exhibit #29 was also on exhibit #30 as having given the firm most of its commission business (437). Exhibit #31, "1967 Service Commissions" gives net service commissions earned by the firm in that year and substantially duplicates the names on exhibits #29 and #30 (438). These 20 fund managers service practically all of the major funds in the country (438). Exhibit #32 shows "December Sales and Service Commissions" for 1966 and 1967 (439). It compares total sales by the firm on behalf of the fund managers. The witness explained that, as an internal record-keeping procedure, the firm's mutual fund service commissions are allocated to the various branch offices in terms of the funds that the particular offices sell. By this procedure, records are kept of the amount of service credit each office has earned (440-441). The firm does not have problems in trying to use these ratios for determining whether the firm receives enough brokerage from a particular fund manager in return for sales of that fund's shares, because fund managers have generally been generous in allocating brokerage and net service commissions to the firm (442-443).

Variation in Give-up Percentages

Exhibit #33 captioned "Sponsor of Fund, Fidelity Sales, 12 Months" and Exhibit #34 captioned "Sponsor of Fund, Wellington Sales, 12 Months" were introduced (443). These exhibits showed the variations in the amounts given up by the firm at the direction of two of its largest customers (in the case of Fidelity Management, 59%, and in the case of Wellington Management, 8%). In the Wellington Case, Reynolds worked very closely with the management of Wellington in helping them to grow and thereby retained more commission dollars whereas the firm just began to work with Fidelity and therefore retained less. It was also pointed out that from year to year the give-up situation with respect to a particular fund management could vary considerably (447). In no case, however, would the amount given up exceed the maximum percentage agreed upon by the firm and its institutional clients (448).

Give-up Related to Cost of Doing Business

The firm explained that it is able to give up as much as it does on its institutional business because it is relatively less costly to process this type of business. Many of the general expenses of running a brokerage business do not arise from this type of activity (448-449). The firm confirmed the fact that the same type of services are provided to its institutional clients despite those clients' differences in give-up policy (450). Several individuals who are sophisticated investors and who transact a sizeable amount of business through the firm are classified as institutional accounts and are treated as the accounts of individual registered representatives. The firm has never been asked to give up at the direction of an individual and would not do so if it were asked. Because a good deal of time and effort is expended in securing business of this type, the firm must pay out sales commission to one of its salesmen, and it therefore feels that there is no room to allow for a give-up (450-452). About 5% of its total give-ups have been paid at the direction of banks and insurance companies (452).

Give-ups Within One Fund Complex

A discussion was held concerning Reynold's business with the Wellington Management Group including the Wellington Fund, the Ivest Fund, and the Gemini Fund. The witness was asked whether Wellington Management was giving up commissions from the Wellington Fund brokerage to Reynolds in order to reward the firm for selling more shares of Ivest Funds. Although this question was not answered directly, the witness said that reciprocity had something to do with this (452A-456).

Reserve Accounts, Give-up Instructions, and Payment for Services

With respect to record-keeping, separate accounts are maintained for each investment company, recording the commissions generated and the amounts given up. Reynolds stressed that it does not give up on a per trade basis but on the basis of the overall account (456-459). Exhibits #35, #36 and #37 are copies of letters to Reynolds on the letterheads of Putnam Management Company, American Fund Distributors, and F. Eberstadt and Co. Each of the letters concerned a give-up to Reynolds from the particular fund. In some cases, Reynolds earned the give-ups involved through the sales of the funds (459-565). Exhibit #35 is a copy of a letter from Putnam Management Inc. directing Reynolds to giveup at the request of Vance Sanders, distributor for the Putnam group. The witness stated that Vance Sanders probably made the request in order to compensate other brokers for their sales efforts and possibly for other services with which Reynolds was not familiar, (461-464). Reynolds estimated that it spends between $150,000 and $200,000 each year in its institutional department and that the amount allotted from mutual fund brokerage commissions to the research department covers these expenses. These amounts allotted to the institutional and research departments are approximately the amount Reynolds would allot to individual registered representatives if these were not house accounts (467-470). Even in the situation where an individual has been classified as an "institution", the firm would not honor a request by the individual to pay give-ups to brokerage firms named by that individual. Reynolds stressed that the investment companies are professionals with whom the firm had business relationships for many years (471-473).

Executions and Block Positioning

There was much discussion about the size of the orders executed by the firm for institutions and the place of execution (473-475). Most of the orders Reynolds receives from investment companies are large in size with perhaps 1/4 of them executed as blocks.

Regional Trades

The firm does not engage in block positioning.

Reynolds gave two reasons for its taking crosses to the floor of a regional exchange: (1) it wants to avoid the seller having to pay a New York State Transfer Tax (474). and (2) investment companies request such procedures (475). There are a number of broker-dealer correspondents who are not members of the NYSE but who are members of the regional exchanges to whom Reynolds gives up part of its commission on the exchange where the correspondent is a member. This is a method whereby the firm is able to reciprocate for the business that is given to it by the sole member to be executed on the NYSE (476-478). Reynolds does not and would not giveup to an NASD non-exchange member, even if the rules of the regional exchange allowed it (479). In a single instance, Reynolds received a give-up check of $50,000 and was requested to giveup 50% of that to certain Pacific Coast Stock Exchange members through executions on the Pacific (Reynolds is not a member of PCSE). This payment has not yet been made (480-486) (Exhibit #39). The firm has not been asked to give up to associate members of the AMEX (487-488).Exhibit #40 is a letter from R. W. Pressprich & Co. directed to Reynolds (488). The letter describes a give-up to Reynolds for the firm's participation in the handling of a large block of stock (488-491).

<u>Other Types of Give-ups</u>

In the remainder of the testimony, Reynolds stated that it does not engage in the 90% floor give-up, does not give up any fees received from the solicitation of a tender offer, does not give up any part of the commissions received on over-the-counter transactions, very rarely executes block transactions in the over-the-counter market for investment companies, does not give up part of underwriting commissions to NASD firms, does not give up any part of an underwriting commission received in exchange distributions or secondary distributions, and has never received finder's fees for placing money in loan accounts.

<u>Policy</u>

The firm distinguishes between give-ups at the direction of fund managers on exchange transactions and give-ups in such areas as over-the-counter transactions, tender solicitations, and under-writings, on the grounds that the funds have more power and control over Reynold's business than do the other sources of income mentioned above. An investment company doing a million dollars worth of commission business has the right to dictate where that commission business goes; it can direct the business to a few brokers and then direct give-ups to compensate other brokers for their services (498-500).

Exhibits

Exhibit #28: recap of all commission emanating from investment companies (422,456)

Exhibit #29: 1967 mutual fund sales (435, 456)

Exhibit #30: 1967 mutual fund commission production (436, 456)

Exhibit #31: 1967 service commissions (438, 456)

Exhibit #32: December Sales and Service Commission, 1967 and 1966 (439, 456)

Exhibit #33: Sponsor of fund, Fidelity, Sales 12 Months (433, 456)

Exhibit #34: Sponsor of fund, Wellington, Sales 12 Months (444, 456)

Exhibit #35, #36, #37: Copies of letters to Reynolds and Co. on the letterhead of Putnam Management Co., American Fund Distributors and F. Eberstadt & Co. directing the firm to make certain give-ups (459-466)

Exhibit #38: letter from Massachusetts Investors Trust to Reynolds & Co., concerning the funds' reserve account (461, 466)

Exhibit #39: letter directed to Mr. Hanson of Reynolds & Co., and memo of Mr. Bach concerning payouts on PCSE transaction (486)

Exhibit #40: letter from R. W. Pressprich to Reynolds & Co., enclosing give-up check to Reynolds, (488, 492)

Exhibit #41: this commission exhibit was reserved for a letter explaining the two transactions referred to on p.p. 481 and 490.

Witness: BACHE & COMPANY

Date: July 8, 1968

Pages: 502 -- 577

TESTIFYING

Mr. Harry A. Jacobs, Jr.,
President of Bache & Co.

Mr. Bruno G. Bissetta,
Assistant Treasurer

Mr. Peter Bernard,
Vice President

Mr. John C. Jansing,
First Vice President and Director

Introduction

Bache is a nation-wide firm engaged in the security, commodity and investment banking business (1503). The firm's securities commission income in 1966 was approximately $79 million, and in 1967, approximately $106 million (504). For the first 4 months of 1968, 13% of the total gross income of the firm was derived from institutional business (504). About two-thirds of the firm's total gross income is derived from security commission income, both individual and institutional (505). It was estimated that about 20% of security commission income is institutional (505). Of the firm's institutional business, 50% is from the banks, 20% from mutual funds, and 30% from all other types of institutional investment (505-506). As the firm's broad institutional business is diversifying, its business with mutual funds is declining as a percentage of the firm's total institutional business (507). However, income from mutual fund sources is substantial. In 1966, total portfolio commissions from investment company orders was $3.5 million; in 1967 it was about $4.3 million. In 1966 gross sales load from the sale of mutual fund shares was about $5.7 million, and in 1967, about $5.9 million. For the first 4 months of 1968, sales yielded approximately $2.8 million (506-508).

Bache is a member of practically every national stock exchange. Although the firm has floor brokers on both the New York and American Stock Exchanges, (508) it pays over $4 million a year for floor brokerage to other firms; during periods then the firm is particularly busy it must give some of its floor brokerage to other brokers (509). The firm has 123 branch offices in the U. S. and abroad and about 1750 registered representatives. Of the 300,000 customers on its books, more than 1,000 are institutional clients (510-511).

Institutional Department

The firm employees 6 people in its institutional department in New York, Investment company orders go to the special handling desk either through the institutional salesmen or directly from the institution itself. The order is then sent to the floor of the particular exchange designated by the client. The order is given to an institutional broker on the floor who has special knowledge and special training in handling large orders that is intended to enable him to operate without disrupting the auction market. The special handling is done in several areas: (1) on the floor of the exchange with the institutional broker, (2) in the block department or the special handling desk, and (3) in the firm's city department which brings to bear on large orders block bidding techniques, exchange distribution, secondary, etc, (512-515). While the institutional broker on the floor is trying to sell the block on the floor, the block department will be trying to find the other side to the order (515). Institutional salesmen are compensated at a rate lower than regular salesmen (516). Most institutional accounts are house accounts covered by salaried institutional salesmen rather than salesmen on a commission basis (516-517).

Block Positioning

When so requested, Bache will position securities for its own account and charge the minimum NYSE commission or an amount equivalent to it. A price is negotiated with the client which is related to the price on the exchange, and then a commission is added to or subtracted from the amount depending on whether the customer is a buyer or seller (517-518). Since the firm is placed in substantial risk in positioning blocks, it does not give-up on these trades (518, 563-564). In May 1968, 20% of the firm's block bids were made for investment companies; the balance was for non- investment companies. The 20% figure was described as typical for the year (564-565).

Over- the-Counter Activities

Bache makes markets in over-the-counter securities to a limited degree and to a limited extent, the firm will service institutional customers who wish to buy securities not listed on an exchange. The firm will cross in the over-the-counter market and will generally charge a commission equivalent to a NYSE commission (518-519). Normally if the firm puts together an agency cross in the over-the-counter market, it will charge both sides a full commission (519-521).

Institutional Research

The institutional research section of Bache's general research department studies in depth particular companies and particular industries. The reports that are prepared are distributed to all of the firm's institutional clients simultaneously. The firm strongly believes that the activities of its research department have substantially contributed to commissions that the firm has received (521-523). Bache does not believe that it would be feasible to bill institutions directly for research services. The explanation given was that the normal way for institutions to compensate a firm that is a member of the various exchanges, such as Bache, is through the use of exchange facilities. Therefore, the commission that the firm charges is not only for executing orders but also for research (524-525). Bache confirmed that less than $200,000 a year of $5.7 million in portfolio commissions is specifically given to the firm as a reward for its research efforts (526-527).

Institutional Business

The record contains the names of the 10 funds for whom Bache sold the most shares in 1967, as well as the firm's 10 largest fund customers in terms of total brokerage commissions (527-528). The parallel between the sales of the funds and the commissions received from them was noted (529-530). Bache explained that the commissions received from these various funds were primarily return for services, including the sale of fund shares, research, secondaries, exchange distributions, and block positioning, with the major service being the sale of shares (530). Dreyfus was cited as the only fund for which the firm does a lot of selling but does not receive brokerage. In this case the firm is getting a much larger fund sales load. Bache also handles a substantial portion of the fund's secondaries and exchange distributions (530-531).

The Exhibit No. 42 shows the total commissions received by Bache broken down as follows: (1) gross commissions for execution, (2) give-up checks received, (3) amount of give-ups paid out, (4) net retained by Bache, and (5) percent of net retained of gross executions. The witness stated that it would be conjecture on the part of the firm to explain why certain funds ask the firm to give up more than other funds (533). At one point the witness said that perhaps the firm's retail sales with respect to particular funds were higher and therefore the retention rate was higher (533). He also stated that there is no relationship between the funds that are recommended to the customers and the various give-up percentages (534). Although the normal give-up percentage is 607, with a 407, retention, in dealing with some of the major funds, the firm retains much more (534). Again the sale of fund shares was cited as a possible reason (534).

From one fund the give-ups received exceeded the commissions received from execution for the fund by 20%; for another fund, its give-ups exceeded execution commissions by 300% (536). The witness felt that perhaps these particular funds wanted to give Bache additional business over and above what the firm had executed for them (536).

From an economic standpoint, the firm would prefer to receive a give-up check in the mail rather than to participate in the execution of an order generating these commissions (538-539). In the past few years, portfolio execution dollars as a percent of each sale of such shares has declined (540). In 1966 the firm paid out 307, of its gross direct business, excluding give-up checks received (541). In 1967 this percent was down to 27% (541). The net payout as a percent of direct brokerage received in 1966 was 467, and in 1967, 38%. The witness did not feel that the drop in the percentage was due to more funds coming into the market thereby creating more competitive pressures on the brokerage industry to sell fund shares (542). He offered no explanation.

The typical method by which the firm gives out commissions at the direction of firms is by check (543). The firm experimented with the four-way ticket on the PCSE but no longer uses that method (543-544).

Approximately 90% of Bache's commissions are earned on the NYSE transactions; about 2 1/2% on the Amex; 2.1% on the Boston Stock Exchange; 1.5% on PBW; 0.6% on Midwest; 2.1% on Pacific; 0.2% on Detroit; 0.6% in the over-the-counter (544). The primary reason for Bache taking an order to a regional exchange is because an institutional client has so directed it (544). Generally, orders that are taken to regionals are agency crosses (544). On occasion, the firm will sell shares on a regional exchange where it does not have the other side (545). In general, there is not a substantially deep auction market on the regional exchanges; however, there have been instances where large orders have been executed on the Pacific after 3:30 p.m. E.S.T. (546).

Reserve Accounts

The firm maintains ledgers for each fund. It summarizes the amount of commissions which are available to the fund each month, records give-ups. and payouts, and sends the funds statements (547). The amount given up is computed at a pre-determined rate (547).

Exhibit No. 43, "Bache & Company Commission Statement, Diversified Growth Stock Fund" shows the reserve account of this fund and a list of pay-outs against the reserve (548). Commissions credited to the account of Bankhaus (a bank in Germany which is owned by Bache & Co.) are also noted as a means of crediting Bankhaus with sales it has generated in Germany (549). These commissions are credited as an internal bookkeeping matter. There is also a reversing entry derived from an instruction from the fund to take the fund's reserve and credit it back to Bache (551).

Exhibit No. 44 was introduced: "Bache & Co. 1967, Manhattan Fund Reserve Account from December 1967 to May 1968" (551-552). It shows F. F., the Bache Frankfurt office with a credit of $30,000. The witness explained that as a matter of internal bookkeeping, a credit was made to the Frankfurt office for various services that the firm had performed (552). Exhibit No. 45 entitled "Bache & Co., Fidelity Trend Fund Reserve Account", was introduced. It shows that Bache sent a give-up check for over $34,000 to Dean Witter & Co. The witness could not explain this payment (552-553).

In every case, the give-up commissions are directed by the fund, so Bache maintains its records by fund rather than by fund complex (554). If Fund A in a complex of funds has $25,000 in commissions and Fund B has $10,000 in commissions, the firm as a general practice will not distribute more than $10,000 for Fund B even though Fund A may have a substantial excess in the reserve account (554). But Fund A might request that Bache transfer amounts from Fund A's account to the account of Fund B. In this way, commissions of one fund might be used for distribution to compensate the recipient for its sales of another fund (555).

Exhibit No. 47, the reserve account of Fidelity Capital Fund was introduced. It shows a payout by Bache of $20,000 to First Hanover Corporation. There was some disagreement as to whether First Hanover was a member of the NYSE (556). [Footnote: The New York Stock Exchange Directory indicates First Hanover is a member organization.] Bache indicated that it would raise an objection if it had sent a check to a member firm after executing an order for that member firm, and then learned that the member firm had sent a portion of the check to a non-member (556).

<u>Other Types of Give-ups</u>

As a matter of general practice, the firm will not give up at the request of an individual. If the firm is paying out commissions to salesmen on individual accounts at a rate which is already higher than the rate it pays to institutional salesmen, it would be uneconomical to give up any more (559-560). In a few instances Bache has given up at the direction of banks and life insurance companies, but this is not its general practice (560). The witnesses stated that even though Bache gives away 60% of the commissions it earns from mutual fund executions, this business is nevertheless profitable for the firm because it is dealing with the funds in a broad range of diversified business (i.e., blocks, secondary and exchange distributions, new issues, etc.) (562-563).

There was a discussion of give-ups in the underwriting field (565). Sometimes a fund has bought a block of stock underwritten by Bache and has asked Bache to include a particular dealer in the selling group so that the included dealer can receive a discount. Bache has complied. This was done once in 1968 and perhaps twice in 1967 (565-568). As an example, Shareholders Management once purchased 80,000 shares, 50,000 shares of which were bought for the group account. The remaining 30,000 shares were bought by SM for selected dealers; Bache was directed to send its check to these dealers (570,571). Bache has not complied with the fund's request in a situation where the fund did not intend to buy the underwritten securities (568).

Bache has not given up on over-the-counter transactions. It has experimented in bringing odd-lots to regional exchanges in order to give up part of the commissions to members of that exchange, but it no longer does this. It does not give up fees received from soliciting tender offers. Nor does it give up to associate members of the Amex. The witnesses did not think that Bache had ever given up to a member of the NYSE who also had a management contract with a fund (572-575).

Bache Exhibits

Exhibit No. 42: Mutual fund commissions (532, 538)

Exhibit No. 43: Commission statement of Diversified Growth Stock Fund (548, 551)

Exhibit No. 44: Manhattan Fund Reserve Account, December 1967 through May 1968 (552)

Exhibit No. 45: Fidelity Trend Fund, Reserve Account from December 1967 through May 1968 (553)

Exhibit No. 46: Mass. Investors Growth Stock Fund Reserve Account (554, 555)

Exhibit No. 47: Fidelity Capital Fund, Reserve Account (556, 557)

Exhibit No. 48: Sample of give-up instructions from Fidelity Fund, Manhattan Fund, Mass. Investors Trust, and Related vouchers (559)

Paine, Webber, Jackson & Curtis
July 9, 1968 -- pp. 580-661

General

Paine, Webber, Jackson & Curtis is one of the oldest and largest investment banking and brokerage firms in the country offering a full line of investment services. The firm has 60 offices throughout the country, staffed by 78 general partners, 31 limited partners, 1,051 registered representatives and 3,479 employees. PWJC is a member of all major national stock exchanges, has eight brokers on the floor of the NYSE, 30 on the Amex, and an employee on the Pacific Coast Stock Exchange (PCSE). PWJC is a specialist on the Midwest Stock Exchange but does not handle the book on the floor. [Footnote: The book is handled by Chancellor Dougall & Co., co-specialist and a sole member of the Midwest Stock Exchange.] PWJC therefore must use the services of other brokers on all regionals other than the PCSE (581-582). PWJC does not act as a correspondent firm for other brokers (614).

PWJC's gross income from all sources (excluding interest income) was $57,663,000 in 1966, and $74,966,000 in 1967. Security commission income represented $48,807,000 in 1966 (74% of gross). and $66,517,000 in 1967 (76% of gross). Income from the sales load on mutual fund shares sold was $4,079,000 in 1967. Commissions on institutional brokerage in 1967 accounted for 25% of gross income (538-587). The firm stated that the percentage of commissions earned on the various exchanges runs 74.5% on NYSE, 18.15% on Amex, 3.45% on Midwest, 1.43% on Boston, 1.21% on PCSE, .81% on PBW and 0.4.5% on Detroit.

Institutional Trading

PWJC has an institutional trading department to handle large block trades. The department has a staff of 17 professional employees and six clerks (589). The firm does not normally position block trades, infrequently attempts to find the other side of a cross, and normally on orders of 2,500 shares or less sends the orders straight to the Floor for execution. The average size institutional order is 2,500 shares. Customers classified as institutions are mutual funds, banks, insurance companies, and pension funds (588-592). Firm salesmen do not share in the profits of mutual fund brokerage business (615).

Research

PWJC maintains a research department which may be used by its institutional department. "The research we prepare is for all our customers. However, in a few instances we have made much more thorough brochures of various securities which we distribute to institutional accounts; but summarizing for our own individual accounts" (635). The firm stated its instructions on the release of research reports are that they are to go to all customers at one time (636).

PWJC said it would not accept give-ups which were to be credited to an individual for research, nor would it pay them out to individuals at other firms (655).

Give-Ups -- General

PWJC receives and pays out give-ups at the direction of institutional customers (Crosby Corporation was cited as an example (595-596), but will not do so for the ordinary customer (654).) PWJC supposed that one reason it received give-ups was that when the fund is buying or selling, a substantial amount of stock commissions are generated with the executing broker in excess of what the fund desires the broker to receive in a particular period of time (597). PWJC stated it paid out give-ups for competitive reasons (647, 654, 658, 659) and that if it did not do so it would probably see a smaller flow of orders into its (institutional) trading department making it more difficult to find the other side to a cross (604, 635, 647).

The firm stated it will not give up on stocks in which it maintains over-the-counter markets (40 stocks) since the price is negotiated, nor has it given up on agency orders executed over-the-counter (613, 636-636). PWJC does not use exchange distributions, commodity trading tenders (603), or send odd lot orders to regionals for give-up purposes (621). PWJC sends odd lots only to one regional, the Midwest (621). The firm will not give-up on block positioning dealer trades (603) and does not use the Pacific Coast 4-way ticket type give-up on regionals (621).

PWJC stated it has given-up on underwritings and secondaries in the past but does not do so now (631-632). Normally the firm gives up by check (622) or through floor give-ups (604). PWJC will give-up to non-exchange members on regionals which have rules allowing this (621). These give-ups are normally crosses by PWJC (626). Most of the give-ups paid out on NYSE trades are to firms that are not represented on the floor (619) and most of those received on the NYSE are from institutional brokerage firms (620).

Method and Amount of Give-up

PWJC stated that normally the form of the give-up is by check (622, 628) with PWJC retaining a minimum of 50% (it executes, clears and confirms the trade to the customers). On an overall basis in 1967 the firm retained 72% of its fund commission (603). It is the habit and custom of PWJC not to give out more than 50% (599). PWJC does not consider the pay-out of 50% of the commission at the direction of Anchor Corporation, for example, to be unprofitable (602). When this type of give -up (by check) is used, PWJC deposits the 50% give-up allocation in a reserve account and waits for instructions from the fund manager (598) which are received weeks or months after the trade (597). If the manager does not ask PWJC to give out the full 50%, the undistributed amount is taken into the firm's "private account." The firm waits for a period of 90 days for instructions before it credits the undistributed give-ups in the reserve account to its private account (659-660).

The second give-up technique used by PWJC is the floor give-up. "We execute a trade for the customer on the Exchange and at the direction of the customer, send a floor report to another member firm, which will bill and clear the transaction. We charge the other broker a floor brokerage fee to compensate us for executing the trade" (604). The firm given up to is actually called upon to perform the clearance and settlement functions on the trade (604-608). A single order executed for the fund may involve combinations of the check give-up and the floor give-up to arrive at the desired total give-up ratio on the order. PWJC described a combination of this split in the instance of the execution of 17,300 shares of Consultants and Designers stock on the AMEX in which 8,000 shares were given up for clearance to Adams and Peck, "Our firm then billed the institution for 9,300 shares and Adams and Peck billed the institution for 8,000 shares." PWJC stated that it received floor brokerage on the shares given up to Adams and Peck and that that portion of the trade was an example of a 90% give-up (648). The name of the brokers on floor give-ups are provided on the same day as the trade (597).

The firm stated that it records commissions earned on institutional trades in three different categories. Commissions received from funds are identified as mutual fund commissions on the firms I&E Report only if the firm has a contract with the fund to sell the funds shares. Commissions received and paid out from funds with which the firm has no selling agreement (captive funds, closed end funds, etc.) are identified as commissions received and paid out of Introduced Accounts Carried For Other Brokers. Other institutional commission income is also reported in this category. Floor give-ups are not reported as fund commissions and give-ups, but are identified as floor brokerage received from other brokers. The firm stated that its mutual fund commission income was reported on its I&E Reports as follows: $3,954,095 identified as mutual fund commissions, $11,324 earned from floor give-ups as floor brokerage from other brokers, and $1,871,000 in commissions from funds and other institutions under the Introduced Account Category (609-612).

<u>General Policy on Commission Sharing and the Services Provided Under the Commission Rate</u>

PWJC's testimony contains conflicting statements concerning who can share in commissions. PWJC stated that the sharing of commissions should only be among Exchange members (652) but also stated that it would give-up to "NASD only" brokers on regional exchanges which permit this (mentioned earlier). From the firm's testimony it is also not clear whether it believes give-ups should be allowed to be returned to the funds. The firm stated that it would and does pay give-ups on regional exchange trades but not on NYSE trades (657). PWJC implied that research was one of the services included in the commission rate and that reward for the sale of fund shares was also contemplated (652-653).

Exhibits

Seven exhibits were introduced during the hearing. Exhibit 49 shows commissions earned, give-ups received, and give-ups paid to others for the ten largest fund groups for 1967; Exhibit 50 shows the dollar sales and commission load received from the top ten funds in 1967, and the brokerage commissions received from each by PWJC; Exhibits 51(a) and (b) are copies of letters from United Funds, Inc. directing PWJC to give-up commissions to Kansas City Securities and Burnhan & Co.; Exhibits 51 and 52 are lists of Amex Associate Members paid give-ups in 1967 and the first quarter of 1968; Exhibit 53 is a set of documents of give-up instruction records kept by the firm.

PWJC has forwarded corrections to Exhibits 49 and 50 originally filed.

SALOMON BROTHERS & HUTZLER

July 9, 1968 -- pp. 661-732

Introduction

Salomon Brothers is primarily an institutional firm, dealing in a number of financial areas, including U. S. Government obligations, municipal bonds, bank interest certificates, railroad bonds, finance bonds, industrial bonds, utility and telephone bonds, arbitrage, common stocks, bank stocks, preferred stocks, and underwriting (662-663).

Sources of Income

Virtually all of Salomon's business is done with institutions; only a minimal amount is done with individual accounts (664). The firm's gross income in 1967 was approximately $88 million (663). Of this figure, about $31 million or 15% was derived from security commission income. Gross income from mutual funds was about $4 million, or 1/3 of total commission income (663-664). Commissions from other than mutual funds amounted to about $5.6 million (664). The firm's other major sources of income, by dollar amount and percent of total income, are as follows: dividends and interest on firm investments, $38 million (40%); profit and loss from trading and arbitrage, $23 million (25%); profit from investment accounts, $3.4 million (6%); and underwriting, $7.9 million (10%) (665-667). The firm also received about $60,000 from other brokers at the direction of various institutions (667). The firm does not sell mutual fund shares (668).

Description of Firm

Salomon is a member of the New York, American, Pacific Coast, Midwest, Detroit, PBW, and Boston Stock Exchanges (671). Since the firm has just one broker on the floor of the New York Stock Exchange, a good deal of its business is executed through floor brokers (671-672). The firm does not have specialists on any exchange (672).

None of the firm's employees work on a commission basis. The production people receive a salary plus bonus, the latter being relative to the firm's overall profit and the individual's production (673).

Common Stock Orders

Although no specific figures were readily available, Salomon estimated that the average size order handled by the firm was in the 5,000 to 10,000 share range (674).

With respect to the handling of orders, all equity orders are funneled into the common stock desk whether they are from the firm's branch offices, from the firm's New York contact men, or from those men already on the specific desk assigned to the handling of mutual funds. The department is broken up into two parts, one side having a trading function and the other side serviced by contact men who are working with some of the key accounts in the country (674).

Salomon described how it put together crosses and executed orders on the floor of the exchange (675-680). Most of the firm's executions are on the New York Stock Exchange. The percentage breakdown is as follows: New York Stock Exchange, 80%; over-the-counter market, 8%; balance on various regional exchanges, 12%.

When the firm has block positioned and negotiated the price for its customer, there are occasions when the order may be taken to a regional exchange (681). The firm may also do a portion on New York and a portion on the regional exchange. If the firm is positioning part of the order and crossing the remainder, it may take the part that it is positioning to the regional in order to avoid the print (685) and consequent publicity.

Block Positioning

Salomon is one of the largest four or five block positioning firms (686). If an institution cannot find the other side of a cross, it will often seek the services of a block house, such as Salomon, which is willing to risk its capital by taking the stock into its own account (686-687). The reasons the institution will go to Salomon were cited as follows: (1) Salomon's market expertise; (2) its willingness to commit capital; and (3) its excellent institutional coverage.

The average amount of capital committed to positioning at any one time may range from $3 to $15 million (688). The firm's positioning activity has increased substantially in recent years. It receives two full New York Stock Exchange commissions on a cross, but when it is positioning a block, it receives just one full commission. The firm bids for positioned blocks on the basis of what it feels is the market at that given moment (690).

Give-ups and Block Positioning

The firm's policy is not to give-up on any portion of a block that it positions (691). It believes that to give-up in this situation somehow would be "illegal" but was unable to specify under whose rules (691). If the firm has positioned part of a block and crossed the balance, it will give-up on the non-positioned part if so requested (691). Salomon believes that it must give-up in a situation like this, even when its capital is at risk for part of the block, in order to remain competitive (692). It also believes that it can make money this way (693). The firm was hesitant to confirm the statement that the same dollars are involved whether the firm has block positioned and the stock goes down a quarter of a point or the firm has given away a quarter of a point on the clean side of the cross (693). The firm stressed that it obviously hoped to make a trading profit on the positioned portion, and that in any case it had the commission on the crossed part to serve as a buffer. Salomon is willing to reduce this commission buffer by giving up a portion of it even though the capital of the firm is substantially at risk (694). The prime consideration to the firm is that it has bought the stock at the right price (694).

Salomon would still be willing to block position if give-ups were abolished resulting in more commission dollars to be retained on the non-positioned portion. The firm's concern is whether or not it thinks it can make money on the trade; trading judgement is the crucial factor, not the commission received (695). Salomon would not comment on what effect an institutional volume discount might have on the firm's block positioning practices (695).

Give-Up Arrangements and Percent Given-Up

Salomon typically gives-up 50% to 60% of commissions earned from mutual funds (696). The firm will also give-up at the direction of other types of institutions, such as banks or insurance companies (696).

Exhibit No. 54 is entitled, "Gross Commissions, Mutual Funds, January 1, 1968 through March 31, 1968" (696). A discussion ensued pertaining to differences in give-up percentages, ranging from 0.69% to 50%, and the reasons for these differences (697-701). The average amount given-up during the quarter was 33.6% (698). [Compare this with the 50% to 60%, maximum figure given earlier (699).] The commissions shown in the document include commissions from principal transactions. Low percentage give-ups indicate that the firm has done more block positioning for that particular account than for one with a higher percentage of give-up (699-700)

Exhibit No. 55 is entitled "Journal No. 11 and Journal No. 20," and shows the reserve accounts of particular funds (702). The variation in give-up percentages appear here also.

The firm's placement of a block does not depend on any give-up arrangement with its customers. For example, if it has found two buyers for an institutional order, one of which is a fund which consistently requests a 50% give-up and the other which does not ask for a give-up, the order will be split down the middle (704).

<u>Two Large Block Trades -- AVCO and Gillette</u>

Two of the largest trades that Salomon has ever done were discussed on pages 704 through 715. One was a block of some 477,000 shares of Gillette and the other was a block of some 340,000 shares of AVCO. At one point during the Gillette trade, Salomon was at risk to the extent of $21 million (706). It gave away $48,000 in commissions on this transaction (707) By the end of the day of the trade, the firm's risk commitment was down to around $10 million (708). Salomon was asked whether, with respect to this trade or any other trade where it has partially block-positioned, it would be willing to pay perhaps 1/8 or 1/4 of a point more to the seller and not give-up the commissions on the trade (709). The answer was no. Again, the firm would not recognize these as the same dollars. It stated that the important thing is the price at which it buys the stock and puts it on the tape (709). Salomon gave-up about $125,000 at the direction of its clients on the AVCO trade; it positioned only a small part of the block (709-712).

<u>Miscellaneous Give-Ups</u>

The firm does not give-up any portion of the commission or dealer profit on over-the-counter transactions (713). There was some discussion as to execution pursuant to Rule 394 (714-716), and in conclusion Commission Exhibit No. 60 was reserved for comment by Salomon Brothers as to the nature of an exchange's rule-making jurisdiction over unregistered securities (730-732).

The firm has never been asked to give-up at the direction of an individual investor or to give-up in situations where it has solicited a tender offer. Salomon has sometimes given up part of its selling commission (but no part of its underwriting commission) to NASD dealers named by investment companies. Also Salomon will permit a firm to participate in a secondary at the direction of a fund or other institutional investor who is buying. In the latter two situations, Salomon has acquiesced reluctantly, and only if the particular deal needed help (727). If the fund is not going to buy, Salomon will not give-up (728-729).

Exhibit No. 56 shows a series of letters from banks instructing Salomon to give-up on certain transactions. Exhibits No. 57 and No. 58 show similar letters from an insurance company, a pension trust, a corporation, a hedge fund, and an investment adviser.

DONALDSON, LUFKIN, AND JENRETTE, INC.
July 10, 1968 -- pp. 736-852

Introduction

Mr. William H. Donaldson, President of Donaldson, Lufkin, and Jenrette, Inc. (Donaldson hereinafter), testified. Donaldson was founded in 1959, and is primarily engaged in research and block trading for institutions (737-738). Its research activity includes economic analyses, specific industry and company studies, and computer-based technical market studies. The firm is also active in the execution of large scale purchase and sale programs for its institutional and professional investor clientele. The firm was called to testify as an example of a research or institutional house; Donaldson does not do a general brokerage business with the public or with individual investors, does not sell mutual fund shares, does not have a branch office network, does not have commission salesmen, and does not participate generally in public underwriting or distribution (738-739).

Donaldson's gross income for the year 1967 was about $21.9 million (739). Security commission income represented 85% of this figure (739). A substantial part of the balance of the firm's income is profit from investments (739). This is strictly profit from capital accounts and does not represent profit from the firm's positioning activities (739-740). Donaldson does business almost entirely with institutions or with professional individual investors who have institutional characteristics (741). Its primary business is with mutual funds, pension and profit-sharing plans, private trusts, banks, investment counselors, insurance companies, and other institutions (741). Its institutional commissions come in the following proportions: 32% from the mutual fund; 18% from pension and profit-sharing plans, endowments, and charitable foundation; 15% from private trust funds; 12% from banks and trust companies; 5% from investment counselors; 3% from insurance companies; and about 15% from foreign miscellaneous (741-742). Individual investors account for from 5% to 7% of the firm's total business (742).

Research Department

Of the firm's 275 employees, 120 are professional staff members; about 60 of these spend the majority of their time in the research operation (738,744). There is extensive discussion in the transcript of Donaldson's research activity (744-757). The firm has a client list of institutions with very different sets of investment objectives (744), and, accordingly, Donaldson operates on a multi-level relationship with its clients. For example, the firm's industry specialists will consult with their counterparts at the various institutions, and, at the same time, people from the firm's policy group will deal with the portfolio managers of the institution. People from the firm's economic group and technical market capabilities group speak with their counterparts at the institutions (745-746). This is also true on a trader to trader basis (746). Donaldson has five officer stockholders who act as its coordinators to insure that the right people in the firm are speaking to the right people at the institutions (736-747).

The process of developing an investment recommendation from the lowest level to the highest level in the firm was described (747-749). The firm's policy on information of general interest to a class of its clients or to all of its clients is to disseminate that information simultaneously (750), but it is difficult, in practical terms, to adhere strictly to this policy (750-751).

In its operation, Donaldson attempts to relate the amount of business it is doing with an institution to the cost involved in serving that institution (752). It also attempts to relate the compensation it receives to "value added," (i.e., value of its services to the client) (752-753). by keeping very close records of the relative correctness of its economic judgment and the performance of the investments it recommends (753). The firm also closely watches the institutional portfolios that it is advising, the securities in those portfolios and the strategy that the firm feels responsible for (753). The firm expects to be compensated primarily by commissions (754), but occasionally it has received direct cash payments for research (754).

Block Positioning

Donaldson is a major block positioning firm (763). A sample test run during two months of 1968 revealed that the firm positioned stock in approximately 25% of blocks of 20,000 shares or above; the firm positioned stock in about 12% of orders in excess of 10,000 shares (759). In blocks of less than 10,000 shares, the firm positions less (759).

Donaldson does not give-up on the portion of the blocks that it positions. The firm will, however, give-up on the portion of the block that it crosses (760). The amount given-up may vary, depending on the percentage of the block positioned. Fewer dollars are given up when the firm positions a large part of the block (761). The firm has an average of approximately four or five million dollars of capital committed at any one time to block positioning (approximately two-thirds of the firm's total capital) (765). The most capital that the firm had committed at one time in one position was six or seven million dollars. In 1967, the firm lost money on its principal account in the block positioning area, and at the time of the testimony, was making money in 1968 (763). Donaldson is happy to break even in its trading account on block positioning (763-764). Donaldson recognized the fact that the firm is at substantial risk in its positioning activities and explained that the reason the firm is in this business is to provide liquidity for its institutional clients in a market place which, for one reason or another, does not have the depth to accept the order. Also, the firm is competing for the commission dollar and hopes that its positioning will encourage institutions to reward the firm with easy orders for having taken harder ones (766). The problems of shopping a block were also discussed (768-769).

Putting The Crosses Together

The techniques used in putting crosses together were described (770-771). Less than a majority of orders in excess of 20,000 shares result in crosses (771). A sample run for the eleven trading days between May 1 and May 15 revealed that the average size order was about 6,600 shares. The mean average transaction to fill that order was 2,300 shares. Stated another way, it took about three transactions to complete that order (771-772). The firm had a considerable number of transactions in filling those orders that involved less than 600 shares (772).

Security Commission Business

In 1967, the firm received over $18 million in gross security commissions, of which some $4.8 million was received directly in brokerage commissions from mutual funds. Give-ups received were $423,000 and give-ups paid out were $1.261 million, leaving a net give-ups paid figure of $837,000. [Footnote: The

$1,000 discrepancy is unaccounted for in the record.] In the same year, the firm paid out over $1 million on the New York Stock Exchange in floor brokerage and almost $300,000 on the American Stock Exchange (784-785).

Donaldson has two members on the floor of the New York Stock Exchange and, as an associate member of the American Stock Exchange, does not have a floor broker there (785). The firm is not a member of any other stock exchange. A substantial portion of the orders which the firm executes on the floor of the NYSE are handled by other brokers to whom the firm pays floor brokerage.

Give-Ups

The percent of the commissions that the firm gives-up varies. On each order that is received, the firm negotiates with the institution, attempting to appraise services involved in the transaction, such as research, economic services, block positioning, and trading expertise (773). The maximum that has been given-up on one transaction is 70% (773-774).

Give-Ups Received

Donaldson stated that the give-ups received are primarily as compensation for research and other economic services. There also may be give-ups directed by floor brokers for Donaldson's participation in block transactions with these brokers (786-791). The firm is not a seller of mutual fund shares, and therefore is not receiving give-ups for this reason (787).

Give-ups Paid Out

Of the $4.8 million that the firm received in direct brokerage from mutual funds in 1967, Donaldson gave up at their direction $1.3 million (791) Stated in terms of percentages, the firm retained about 75% and paid out about 25% in the form of give-ups (792). The $4.8 million included brokerage on orders that the firm had block positioned without giving-up (792). Of the $2.4 million in transactions on which orders the firm did give-up, about million or some 54% was paid out (793).

Approximately $480,000 was paid out in the form of give-ups to other firms at the direction of managers of institutions other than mutual funds. This type of institution includes banks, insurance companies, private funds, some pension funds, and a few investment advisers. The firm has also given up at the direction of individuals that have an institutional characteristic to their operation (794-795).

Major Mutual Fund Clients

Exhibit No. 61, entitled "Commissions received from Mutual Funds for the year ending December 31, 1967," was introduced. This exhibit reflects the names of the firm's top ten fund customers, gross commissions received from these funds, give-ups received, give-ups paid, and net commissions retained. Mr. Donaldson was asked to read the names of each management group on the list, but strenuously declined on the basis that to do so would be a violation of the firm's client relationship. However, the firm had not received any formal communications from the individual fund-clients requesting that information on the fund's brokerage business with Donaldson not be disclosed (797-798). Mr. Donaldson could see no relevance to making this information public and furthermore, feared possible competitive disadvantage to the firm and to its clients from public dissemination of this information (798). There is further discussion on this subject on pages 798-801, during which the presiding officer ruled that the question by the Commission attorney was appropriate (800).

The exhibit reflects that the net retention rates range from 55% to 100%. The explanation for the variation is that in the course of the firm's negotiations and discussions with its clients, it attempts to assess values of the services that it has performed or will perform for the client (802).

The firm's business relationships with specific brokers and firms were discussed. Mr. Donaldson did not know what Leif, Werle and its successor in this regard, Jeffries & Co., did with give-ups which the firm paid to them (803). In 1967, the firm had a 100% retention of brokerage on business with Hamilton Management Company, and thus far in 1968 had not done any business with this firm (803-804). With respect to the Fidelity Management Company, where the firm retained over 70% of the commission, the management group had both directed give-ups to the firm and had directed that the firm pay out give-ups in about an equivalent amount. Mr. Donaldson explained that where give-ups were received, these would perhaps be executions that were done with other firms acting as prime brokers but where Fidelity was rewarding Donaldson for its role in originating the order. Therefore, the fund directed the executing broker to give-up commissions to Donaldson. In other situations, Fidelity may have used Donaldson as a lead broker and asked that the firm share the commission with other brokers for services performed (805-806).

For the bulk of the firm's clients, the give-up is discussed on each transaction, and each order has a notation of the agreed upon give-ups (807). Exhibit No. 62 concerns a give-up to Delafield and Delafield, another member firm. In this situation the order was executed by Donaldson and carrying of the account was given up to Delafield, and Delafield billed the customer, in this case, Investors Overseas Services, for the commission (808-810). Donaldson had found both sides of the cross, collected 100% on the side where the firm carried the account, and on the other side, billed for floor brokerage plus 50% of the commission.

Therefore, on that side, the firm retained about 60% and Delafield retained about 40% (809).

Exhibit No. 63, a letter from Burnham & Co. dated May 12, 1967, was introduced. Attached to the letter was a document entitled "Give-Ups Receivable, May, 1967" (810-811). Exhibits 63, 64, and 65 were introduced. These are sample letters notifying Donaldson that it would either receive a give-up check or should pay out give-ups to certain broker-dealers (811-815). One letter involved the receipt of a give-up check from a hedge fund (811-812).

Other Give-Ups

The firm has not been asked to give-up to an associate member of the Amex. In the few underwritings in which it has engaged, it has not been requested by a mutual fund manager to pay part of the underwriting commission or selling group commission to a member of the NASD. It has not paid nor been asked to pay fees arising from a solicitation of a tender offer to a member of the NASD or any other registered broker-dealer. Donaldson does not receive any income from finders fees for placing money with savings and loan associations, The firm would have no policy against negotiating a give-up to a member firm of the NYSE which is directly or indirectly an advisor to a mutual fund (816-818).

Policy

The remainder of the testimony was devoted to a discussion of the theory behind the minimum commission schedule, the effect that a change in that structure and an abolition of the give-up would have on the firm's business, and the impact of further institutionalization on today's market (775-780, 818-852). Mr. Donaldson testified that the minimum commission schedule is for a range of services generally associated with and related to the creation of the transaction. This involves all phases of research, execution, clearing and physical handling, in addition to risk taking after the transaction (818-819). It was pointed out by the questioning attorney that despite the fact that the firm like Donaldson renders a much broader range of services, it is willing to give-up as much as 50% of the commission. The explanation was given that each firm puts its own set of values on the range of services that it is providing. There is also the outlet of the third market (822). With the give-up technique, an investor is able to direct the commission dollars to the various people who have provided services (823). Relating services that the various firms provide to the amount of commission dollars that are retained, Mr. Donaldson stated that the firm gives-up about 17%, Salomon Brothers, who is just providing market expertise, gives-up an average of 33%, and Jeffries, which is strictly an execution house, gives-up in the 90% area (824).

Mr. Donaldson believes that the mutual fund managers have the resources of both management fees and brokerage commissions available in order to achieve investment performance of the fund (824). In this respect, the brokerage commission should be more than just an execution charge; it should include, in addition, compensation for a range of other services that are vital to the investment process (824-825). Donaldson does not believe that an investor in a mutual fund is paying for the same services twice, as he is getting essentially two different sets of services (827-828). Without the resources of brokerage commissions, the funds would have to do without those services for which commission dollars are used to compensate, or the fund's shareholders would have to pay for those services some other way. (Mr. Donaldson testified that he personally did not believe that any part of the commission dollar should be used to compensate for the sale of fund shares [829].) In a minimum commission structure, you have the ability to get commissions out to the people that are performing services (829-830). By reducing the commission, you are reducing the availability of dollars for services (830).

Mr. Donaldson feels that a fixed minimum commission schedule allows a small investor on a dollar for dollar basis to attract resources and services that prevent him from being at a disadvantage to a large investor. Without the minimum commission schedule, the large investor would have tremendous economic resources that would enable him to compete unfairly (832-833).

Although a volume discount would give credence to the elements of clerical and administrative handling expenses of the commission, it would not encompass the value-added nor the risk element of the commission (833).

Donaldson was asked why mutual fund managers should not pay cash for the services, such as research, that are rendered to them. The firm feels that (1) the fee structure in the mutual fund industry is based on the fact that funds have brokerage dollars that can buy services and without that fee structure, there would have to be an adjustment so that there would be enough dollars for the managers to attempt to buy the services; and (2) the minimum commission structure has enabled firms like Donaldson to go into the business by building an organization, taking all the risks inherent and building value. Without the minimum commission structure, or with too "violent" a volume discount, the rewards that are available to firms like Donaldson would be destroyed and therefore less value could be delivered (776-777).

There is a general discussion on the institutionalization of the market place and in particular, the reasons for the rapid and tremendous growth of the mutual funds (836-841). There is also discussion on relating commissions to the sale of fund shares and relating research services to the performance of fund clients (843-847). The remainder of the testimony is devoted to a discussion of give-ups as a realistic trade practice, the services involved in the commission dollar, and the risks assumed by brokers (848-852).

CANTELLA AND COMPANY
July 10, 1968 -- Pages 853-903

Introduction

Vincent Cantella was called to testify about his firm's activities insofar as it uses its Boston Stock Exchange membership to duplicate New York Stock Exchange transactions on the Boston Exchange and thereby make use of the Boston rules permitting give-ups to NASD dealers at the direction of the firm's institutional clients.

Mr. Vincent Cantella and his wife are the principle stockholders of the Cantella firm, together owning 100% of the stock (853). The firm is a member of the Boston Stock Exchange, the Midwest Stock Exchange, the Pacific Coast Stock Exchange, and an associate member of the Philadelphia-Baltimore-Washington Stock Exchange (854). The firm employs sixteen persons, nine of them on the floor of the Boston Stock Exchange and the others in the office (854). Cantella is a specialist in 19 stocks on the Boston Stock Exchange (855). He has no floor broker and does not act as specialist on the other exchanges.

Sources of Income

Gross retail commissions, that is commissions charged to non-members, from January 1 through June 30, 1968, approximated $1.5 million (856). Over $1 million of that was derived from retail commissions from mutual funds (856). Commissions from broker-dealers accounted for most of the remaining $400,000 (857). In the same period the firm earned over $600,000 in floor brokerage (857). Basically, the firm provides a service of executing orders for other member firms on the floor of the Boston Stock Exchange and does almost exclusively an institutional customer business at the full commission rate. Cantella accounts for about 80% of the total floor brokerage on the Boston Stock Exchange (858).

Handling of Institutional Orders

Cantella has about 40 mutual funds as clients representing 10 to 15 fund complexes. With respect to the handling of an order from a mutual fund, the following description was given. The trading department of the fund will call the firm and give the firm an order to buy or sell, normally in the range from 5,000 to 50,000 shares. The firm will first check with the specialist on the floor of the Boston Exchange to see if he has stock available. Then the list of indications of interest will be checked. Cantella is also in constant communication with more than 50 firms whom it represents on the Boston Stock Exchange. The firm generally does not have both sides of an order; perhaps in less than 5% of the orders does it have the entire other side (860). However, the witness indicated that it is finding the other side more and more often. He estimated 10-25% of his volume is done on Boston, either with the specialist or in a cross (892-93). If they are unable to find the other side, then the firm will enter the order on the New York Stock Exchange for its own account (860-861). As Cantella is not a member of the New York Stock Exchange, it must use certain brokers, such as Paine Webber, Hertz, Neumark, First Hanover, Oppenheimer, Model Roland, who are members. The member firm is given the instruction not to shop the order looking for the other side of the cross (862-863). That member firm will execute the order and charge Cantella a full commission. The details of the execution process and exhibits reflecting the fact that Cantella pays the full New York Stock Exchange commission were discussed on pages 863-866.

<u>"Mirror" Trade on Boston Stock Exchange</u>

Mr. Cantella testified extensively on his "mirror" trades on the Boston Stock Exchange. Where the institutional client has requested a give-up under the liberal Boston Stock Exchange give-up rule, Cantella may be able, through his "mirror" trade procedure, to get the customer by what is in effect a New York Stock Exchange execution and a Boston give-up duplicating the New York transaction on Boston.

As described earlier, when Cantella cannot find both sides to a transaction, he will send the order, for his own account, to the New York Stock Exchange for execution. The moment he receives the report of the New York execution reporting, for example, a sale of 500 shares of stock at 50-1/2, the firm will immediately buy 500 shares of stock for its own account at the same price, 50-1/2, on the Boston Stock Exchange from its client. In other words, the firm is executing the order on Boston at the identical price at which it sells the stock on the New York Stock Exchange.

An example of the entire execution is as follows: A fund gives Cantella an order to buy 5,000 shares of a stock. The firm buys the 5,000 shares for its own account on the New York Stock Exchange. As soon as the firm has the report of the New York execution, it will sell on Boston the same number of shares from its own account to its fund client. The price that Cantella charges the fund for that simultaneous purchase is the price Cantella has just received from the member firm on the New York Stock Exchange floor execution. Cantella, in fact, uses the exact identical ticket (867-868).

Cantella then confirms the Boston trade to the customer, stating that it was a principal transaction and charging an equivalent exchange commission in accordance with the exchange rules (868). The customer is aware of the New York transaction. Cantella has paid the New York broker a commission of, for example, $1,000. In accordance with the confirmation, Cantella has to receive $1,000 in commissions from the fund. As the prices are the same, the commissions are the same. The fund has an execution on the Boston Stock Exchange and Cantella has an execution on the New York Stock Exchange (869-870). At this point, the firm is breaking even.

The fund will usually instruct Cantella to pay 50% of the commission to other broker-dealers who are either members of the Boston Stock Exchange or NASD members (871). Under the Boston rules, a member firm can give-up 50% of its commission to another member or it may give-up 40% to an NASD member and 10% to a member firm (871-872). The witness pointed out that the Boston Stock Exchange is the only Exchange which allows give-up checks to NASD members on unrelated trades (900). [Footnote: An unrelated trade is the trade of a customer other than the customer who is directing the give-up.] He estimated that between 15% and 20% of the give-ups on that Exchange went to member firms with the balance to NASD members (891). Exhibit 71 was submitted, showing the distribution of give-ups by Cantella at the direction of various brokers and funds (892).

At this point in the transaction Cantella is minus $500. He has paid out $1000 in commissions on New York, he has received $1000 in commissions on Boston and he has given up $500 on the Boston trade. Mr. Cantella pointed out that the firm is not actually minus this money, as a matter of cash flow, but that for purposes of outlining the procedure, it would be correct to say that it is minus the $500 (873).

Reciprocity with New York Member Firms

Cantella makes up this deficit and makes a profit for himself on the transactions through various reciprocal arrangements with the fifty brokerage firms he represents on the Boston Stock Exchange. It was Cantella who sold many of these firms, most of whom are NYSE members, their seats on the Boston Stock Exchange. He pointed out that letting Cantella act as their floor broker would be profitable because of the reciprocal arrangements which he offered (885-86). Cantella gives them NYSE commissions, they return commissions to him through floor brokerage on the BSE, through give-ups on the BSE, and in some cases by give-ups on over-the-counter trades (876).

Cantella pays NYSE commissions to these brokers in two ways. He may give the firm orders to execute on the floor. However, it is not efficient to give fifty different firms orders for execution. So Cantella gives direct executions to a limited number of firms, First Hanover and Hertz Neumark in particular, and directs give-ups on some of these trades to other NYSE members (874-75, 886-87).

Hertz Neumark is the major firm Cantella uses to distribute NYSE give-ups. They are directed to give-up about 70% to other NYSE members. These give-ups paid to non-executing members are returned to Cantella principally through floor brokerage given to Cantella on the Boston Stock Exchange. The arrangement is that Cantella, will receive $1 on floor commissions for every $1 in NYSE commissions it directs to others (873-74, 882). Hertz Neumark also reciprocates by giving Boston Stock Exchange and over-the-counter give-up checks to Cantella. After various adjustments Cantella estimates that he recoups either in floor brokerage or in give-ups received by his firm about $900 of every $1000 in commissions it generates. Following the example used earlier, from a minus $500 position, Cantella is now ahead about $400 (883-85).

<u>Floor Brokerage for Crosses</u>

Exhibit No. 70, entitled "Floor Commissions -- January 1968 through March 1968" was introduced. It is from this list that brokers are selected to receive reciprocals on the NYSE although not all brokers ask for reciprocals. Part of these commissions represent purchase crosses where a New York member phoned Cantella and asked to make a cross at a certain price. A floor commission is charged on one side. In this situation Cantella may help put together the cross, still receiving only floor brokerage. In one particular month, the firm of Jefferies paid Cantella $25,000 in floor brokerage (889-91).

<u>Boston Stock Exchange Give-ups</u>

Cantella may receive reciprocals through give-up checks directed to it on the Boston Stock Exchange. Exhibit 73 was introduced, reflecting give-ups received by Cantella on Boston Stock Exchange executions (900). This type of arrangement was discussed in particular in connection with First Hanover Corp. First Hanover executes on the Boston Stock Exchange and then within the rules of the Boston Stock Exchange shares its commissions with Cantella. First Hanover's customer is not notified that his trade is being used as the basis for a give-up (876-80).

Hertz Neumark also reciprocates by giving up on Boston Stock Exchange trades (883) as do some firms which are recipients of giveups at the direction of Cantella on the New York Stock Exchange (900).

A particular situation involving an arrangement with Mitchum Jones and Templeton was described in detail (901-03). Mitchum Jones had directed a give-up check of $32,000 to Cantella. This represented give-up commissions which under Boston rules could be paid only to a Boston Stock Exchange member (see earlier discussion on Boston rules p.3). In return for this $32,000 Cantella agreed to give-up a somewhat smaller amount at the direction of MJT to NASD members. For this, Cantella used his own agency trades where he had extra give-ups available which could be paid to NASD members.

<u>Over-the-Counter Give-ups</u>

Hertz Neumark and First Hanover reciprocate for the NYSE business directed to them by executing for their clients in the over-the-counter market and then sharing their commissions with Cantella (878, 887). Exhibit 68, reflecting the over-the-counter commissions received by Cantella, was introduced.

A copy of a letter from Hertz Neumark to Cantella, transmitting an over-the-counter give-up check was also submitted in evidence (Exhibit 69). The give-up check was accompanied by a ledger of Hertz Neumark's over-the-counter transactions covering a seven day trading period; the give-up check was for half of these over-the-counter commissions. Cantella indicated that he had nothing to do first hand with the over-the-counter market, would not know who the customers were, would not solicit any of the customers, did not make markets in over-the-counter stocks, and was aware that he was receiving a check from over-the-counter commissions only from the letter accompanying the check (878-79, 881-82). Mr. Cantella files the over-the-counter ledgers in a cabinet marked over-the-counter trades. He stated that he did not know if Hertz Neumark would violate NYSE anti-rebate rules if it sent him merely the give-up checks without an accompanying over-the counter commission ledger.

<u>Reasons for "Mirror" Trade</u>

Cantella was asked why a fund does not go directly to the New York Stock Exchange member, but chooses to go to Cantella. The reasons given were as follows: (1) the funds will thereby get exposure to practically all of the New York Stock Exchange firms that have an institutional department (894); (2) they will receive a primary execution on the balance; (3) they will be able to give a regional give-up check (894-895).

With respect to the type of transaction that constitutes most of Cantella's business as described above, Mr. Cantella did not think it was fair to characterize this as a "mirror trade," because there are two separate transactions and two sets of SEC fees paid (895). The firm has actually committed its funds, therefore it would not be fair to call this a wash sale (896). If something went wrong with the order, the firm would be committed on its sale or purchase in New York. Although this has not happened to the firm, Mr. Cantella believes it could happen, and therefore a risk is still involved (896).

American Stock Exchange Executions

There was some discussion of Cantella's American Stock Exchange executions through the firm of Dishy-Easton (898-900). These represent executions of orders received from other brokers, not from funds. It was pointed out that these executions are not repeated on the Boston Stock Exchange and that to return a portion of these commissions back to the brokers, Cantella will send them a Boston Stock Exchange give-up check on unrelated business (899).

Exhibits

Exhibit 66 is a list of commissions paid by Cantella to NYSE firms for trades executed on the NYSE. Exhibit 67 is a list of commissions received by Cantella from designated mutual funds while Exhibit 70 reflects floor commissions received by Cantella from various specified brokers. Exhibit 68 summarizes over-the-counter give-up checks received and Exhibit 73 lists give-up checks received by Cantella on Boston Stock Exchange transactions, while the amounts of give-ups paid out by Cantella at the direction of designated brokers and funds is given in Exhibit 71. Each of these exhibits reflects figures for January, February and March 1968.

Exhibit 69 consists of a copy of a letter from Hertz Werner to Cantella dated April 1, 1968 relating to an over-the-counter give-up being paid to Cantella. Exhibit 72 was reserved for monthly figures of the percentage of executions done on the Boston Stock Exchange vs. the New York Stock Exchange.

A. I. JABLONSKI CO., INC.
July 11, 1968 -- pp. 907-962

Introduction

A. I. Jablonski & Co., Inc. is a member of the Midwest and Detroit Stock Exchanges. Jablonski distributes regional commissions by check give-ups (912), by floor give-ups (921-922) and by placing reciprocal business with two correspondent brokers. The firm was called primarily to discuss its give-up practices.

The firm has two stockholders, each holding a seat on the Midwest and trading from its floor. One member, August Jablonski, acts as a specialist in seven stocks and as a floor broker for some brokerage accounts. This portion of the firm's activities account for 5-10% of the firm's total net profits. The second member of the firm, Robert Jablonski, who testified for the firm, operates the firm's institutional department. Jablonski & Co. uses an independent broker to execute orders on the Detroit Exchange and is assisted by another independent floor broker on the Midwest floor. The firm uses two correspondents to execute trades on the NYSE. The firm does not sell mutual fund shares, participate in underwritings, over-the-counter business, or service public customers on a retail basis. The firm's institutional trading department services mutual funds, banks and insurance companies (908-911).

In 1967 Jablonski's gross commission income from institutional customers was $4,300,000 of which $2,800,000 came from Detroit trades and $1,500,000 from the Midwest. Of these amounts the firm gave up $1,250,000 (44%) on the Detroit and $369,000 (25%) on the Midwest. During the first three months of 1968, the firm grossed $711,000 on Detroit and gave up $313,000 (44%), and grossed $287,000 on the Midwest and gave up $46,000 (16%) (915-917).

Institutional Trading

The finite institutional trading is done from a post on the floor of the Midwest Exchange (910) where it has two direct lines going through its office to institutions and communicates with other institutions on WATTS telephone lines (926,927). The firm is in daily contact with its various institutional customers apprising them of various trading opportunities. These situations are not in the form of firm orders to purchase or sell a particular number of shares but are generally indications of interest obtained from its institutional customers. From these interests the firm attempts to cross blocks either as agent or by block positioning (911-912).

The firm will at times commit itself to a portion of a block of stock on the basis of the clean-up price obtained on the balance which is sent to the NYSE (913).

Amount Given Up

On the Detroit Exchange the firm gives up 40% to NASD members and 10% to members of Exchange. Detroit has a rule which permits a 70% give-up to members, but the firm has not been asked to do this. Mr. Jablonski stated that on the Midwest, its give-up would average 70% [Footnote: The 70% figure (as opposed to 25% on p. 1) results from reducing gross commission income by a part of the 100% commission retained on United Funds trades, and from increasing give-ups paid by including the 90% given up on floor brokerage trades (not reflected in Jablonski's books).] (916); on floor give-ups on Midwest trades the firm gives up the order for execution and clearance thus effecting a 90% give-up. The 10% in floor brokerage earned on these orders is not recorded on the firm's books but is turned over to the independent floor broker on the Midwest as compensation for his services. These services consist of liquidating Jablonski's stock positions and helping to arrange bank financing (912-922).

Jablonski is willing to give up a portion of its commission on trades that it has block positioned as well as on agency trades (917-918). The percentage given-up will not vary even if Jablonski acts as agent on both sides of a cross (922). Jablonski acquiesces in the fund manager's general request that it give up the maximum commission permitted by the exchange on which the trade is executed. Jablonski does not inform the fund manager that it is acting as principal on any specific trade at the time the order is executed but only informs the fund of the capacity in which it acted when the confirmation is sent (918).

Trading Methods

When an investor places an order, i.e. an "indication of interest" rather than a definite order for X amount of ABC shares, Jablonski will attempt to find the other side in order to cross the blocks. If necessary Jablonski will commit itself as principal to a portion of the order "whether or not we can sell it on either exchange which we belong to..." (913). At times Jablonski will accept a risk order even if it is not contemplating execution of the order on an exchange so that Jablonski will be at risk though no commission is available (913).

Jablonski will commit itself normally for a portion of the block at a price based upon what the institutional customer would receive for its portion in New York. For example, assume a 10,000-share block with Jablonski committing itself for 4,000 shares, the stock currently selling at 48. Further assume that it will take from 48 down to 47 1/4 for the sale of the 6,000 share block in New York. The "clean-up" price on the order would then be 47 1/4 and Jablonski would buy its block from the institution at that price. For the customer this does away with the problem presented by the other 4,000 shares depressing the price by perhaps another 1/2 (914): Since Jablonski is purchasing the 4,000 share block for its own account at 47 1/4 the selling pressure on the total block is relieved (913-915). This total inventory maintained from block positioning where Jablonski is at risk averages approximately $1 million at all times (917).

At times Jablonski will have both sides of a cross and one party will request execution on one exchange while the other party requests another exchange. To accommodate its customers on a "transported trade" of this type (923, 932) Jablonski will execute a simultaneous principal cross on the two exchanges buying the stock for its own account from one customer on one exchange and selling it for its own account to the other side on the other exchange at the same price, giving up at the instruction of each fund according to the rules of the respective exchanges. The confirmation sent to both parties will show that Jablonski acted "as principal with a commission equivalent" (923-925). Jablonski has "a very strict rule" that there be no price differential on the two executions, and thus it will neither make a profit as principal dealer at the expense of the two funds, nor take a loss in order to rebate dollars beyond that permitted by the exchange (925). Moreover, the price would be no different if the entire cross were completed on a single exchange since Jablonski is basically "an intermediary between two sophisticated parties... negotiating a price which both parties have agreed to" (926).

In some instances Jablonski will have a pre-arranged cross which has been negotiated for a price which is "out of range" of the last NYSE sale. For example if Jablonski has a 25,000-share sell order at 49 and the last NYSE quotation is 49 1/2, the seller will request that Jablonski have "a print sold in New York where he is thereby in range". Jablonski will take perhaps 1,000 shares of the block and give it to a correspondent who will in turn "sell the stock down to 49" allowing Jablonski to cross the balance on a regional exchange at 49. The shares sold at the take down prices from 49 1/2 to 49 would also go to the institutional customer at those prices. Jablonski does not buy the 1,000 shares at 49 and make a trading profit by selling it at the take down prices; instead the firm sells the 1,000 shares at the same prices it has paid for the stock on the NYSE (927-928).

The effect is to have a tape print in New York identical to the cross on the regional exchange. The institutional customer desires such a print for its own protection in order to demonstrate that there was no actual buyer for the block at 49 1/2 on the NYSE. The NYSE price will generally fall with each offer and if, for example, the correspondent could sell only 700 shares before the price hit 49 then Jablonski would cross 24,300 shares at 49 on the regional exchange secure in its knowledge that there was no market for the complete block at 49 1/2. Since no bid anywhere existed on an exchange which could match the entire block, Jablonski through its expertise has created a cross (927-930). Such service is distinguishable from trades on the auction market and, in fact, Jablonski will only use the "auxiliary market" as a guide to prices.

When the institutional customer wants to reward NASD only members with give-ups, and Jablonski cannot find the other side for a cross, Jablonski can execute through its correspondent broker a dealer trade on the NYSE and by employing a "mirror" trade give up to NASD firms. For example, if Jablonski has a sell order it will buy the securities from the institution on a regional exchange in a dealer trade at the price it sold the shares on the NYSE in a dealer trade, thus permitting give-up to non-members of the NYSE (930-931). These mirror trades bring back to the regional exchange trades executed on the NYSE. "Transported trades" are those where Jablonski has both sides as agent but executes one side on the Detroit in a principal cross and the other side on the Midwest Exchange in a principal cross. These trades make up 60-70% of Jablonski's business with the "greatest percentage" of that transported trades (923-933). Mr. Jablonski insisted that mirror trades are utilized only as a "device of last resort" and that "by far 80 percent, at least, of our orders are done by finding the other side and/or positioning first. ..." (961).

Arrangements with Kansas City Securities

Kansas City Securities (KCS) is a registered broker-dealer and a member of the Pacific Coast Stock Exchange. It is a wholly owned subsidiary of Waddell & Reed, Inc., a management company employed by United Funds (933). Jablonski paid Kansas City in total $519,541.81 in commissions for the year 1967 (962).

In a typical but simplified transaction Jablonski will receive an order from a fund not a part of the united Funds complex, to sell perhaps 3,000 shares of a listed security. Assuming there are no bids matching the offer on the Detroit or Midwest Stock Exchanges to which Jablonski belongs, it will give the order to KCS to execute. Assuming that KCS cannot execute the order on the PCSE, KCS will take the order to the NYSE placing the order with a member firm. Simultaneous with the execution on the NYSE Jablonski will receive a price report from KCS and will immediately buy the security as principal from the fund on the Detroit Exchange at a price identical to the New York tape print. Jablonski then confirms to the fund and Kansas City confirms to Jablonski. Assuming the fund pays Jablonski $1,000 commission, Jablonski will pay Kansas City $1,000 commission and Kansas City in turn will pay the full NYSE commission of $1,000. The fund has thus paid out $1,000 and the NYSE member has received $1,000 and Jablonski and Kansas City are even.

The fund manager, however, will have requested Jablonski to give up a portion of the Detroit Exchange commission paid by the fund -- 40% to a non-member of the Detroit Exchange and 10% to a member. Thus after Jablonski gives-up 50% and pays 5% floor brokerage it will stand minus $550 on the transaction. To make up this deficit and to turn a profit Jablonski will receive reciprocal business from United Funds. United Funds will daily indicate situations in which they are interested and Jablonski will attempt to fill these orders through crosses on the Midwest Exchange and will retain 100% of the commission charged United Funds. Jablonski receives this business from United at a ratio of $1,200 for every $1,000 it gives KCS. This gives Jablonski $650 ($1,200 minus $550) profit on the overall transaction (934-943). At this point Mr. Rotberg stated for the record that for every dollar KCS pays the NYSE member it will receive reciprocal business of $500 (945). The witness, Mr. Robert Jablonski, testified he believed KCS would use a "certain portion" of the $500 to reduce their management fee and that a "certain portion" would stay with Kansas City Securities (947).

Normally the arrangement will be more complex in that Jablonski will "partially block position" (948). For example, out of this order for 3,000 shares Jablonski might place 1,000 shares on the Midwest Exchange and position 1,000 shares, with KCS placing 500 shares on the Pacific Exchange and 500 with its NYSE correspondent. This situation would permit the same arrangement of reciprocal business to Jablonski but KCS would realize a greater profit on the $500 it places on the Pacific Exchange since they are able to retain more commission (948-949).

This arrangement, Mr. Jablonski testified, also benefited the fund inasmuch as it received "broad, top coverage" of "all major markets simultaneously" (947). He indicated that the fund would not receive the same broad coverage by placing an order with a NYSE member who was a member of all exchanges since "in practice, probably, the New York Stock Exchange member would just execute only on the NYSE. (949).

Another method which United Funds and KCS used to get compensation to Jablonski for its reciprocal relationship was to utilize United Fund portfolio securities sold through a tender offer. The Jablonski's name was submitted to receive the tender solicitation fees on a large block of stock owned by one of the United group of funds (959).

The fund placing the original orders with Jablonski were not aware if Jablonski would use a non-member of the NYSE in the trades mirrored through KCS. The funds' names are not disclosed to KCS (941). These orders are handled efficiently and the selling fund will not lose in the execution price. They received a price equivalent to what they could have gotten had they placed the order themselves on the NYSE (941). Jablonski will apparently use this type of trade only if it is the best possible price so that going through Jablonski and Kansas City will not interfere with the orderly flow of executions from the fund to the NYSE, and in fact if there were some "slip up" Jablonski would "give the fund a report on whatever we thought they would be entitled to of our own position" (941, 951-952).

Mr. Jablonski stated that United Funds also has not been overcharged in any respect (946). Jablonski has given United Funds a normal execution performing the important service of finding the opposite side (946, 947). Nevertheless it is "getting some of the compensation because Fund A wished to distribute dollars on the Detroit Stock Exchange to NASD members in connection with their order..." (947-948). On the other hand, the NYSE member will have only ended up with $500" (946).

Arrangements with Arthur Lipper Corporation

Arthur Lipper Corporation is a member of the NYSE, the Midwest, the Detroit, the Boston and the Philadelphia-Baltimore-Washington Stock Exchanges (952). In a typical but again simplified transaction involving the Arthur Lipper Corporation, Jablonski will have received a sell order from a fund which it cannot match on the Midwest or Detroit Exchanges, It will execute the order through Arthur Lipper on the NYSE. Lipper will confirm to Jablonski and charge the full NYSE commission, assume $1,000. Simultaneously, Jablonski will purchase the security on the Detroit Exchange at the same price and will receive $1,000 commission. At this point Jablonski is even but again the fund will direct Jablonski to give up on the Detroit Exchange so that Jablonski is down $550. Arthur Lipper, however, will show Jablonski $1,200 in reciprocal business from the Fund of Funds for every $1,000 in commission that Lipper has received from Jablonski.

Jablonski, for example, will receive "an order from Lipper which reflects one side of a Fund of Funds order" perhaps worth $2500 in commission dollars on the Detroit Stock Exchange. Jablonski will be instructed to give up 40% ($1,000) to the Overseas Development Bank for the account of Gustav Fabre (a member of the Luxembourg Stock Exchange). will credit 40% ($1,000) against commissions paid to Arthur Upper Corporation for NYSE transactions, will pay 5% floor brokerage ($125) and will retain 15% ($375). (952-956) This arrangement was begun in July, 1967 and continues to date (959).

Jablonski never received any tender solicitation fee from Fund of Funds or Arthur Lipper Corporation comparable to the United Funds transaction (960). It has had indications of interest in securities not listed on any exchange of which it is a member. Only once, however, has Jablonski taken an order on an over-the-counter stock for which it had to find the other side (961).

HARRY C. DACKERMAN & CO., INC.
Testimony July 11, 1968 -- p.p. 963-1036

Testifying was Mr. Maurice Waber, Chairman of the Board of Harry C. Dackerman & Co., Inc. (Dackerman) of Philadelphia. Dackerman is an odd-lot and round-lot dealer on the PBW in approximately 115 securities. The firm is floor broker on the PBW for approximately 50 sole Philadelphia members and 8 full members (Witness meant NYSE-PBW member). The firm is also a commission broker for about 70 sole PBW members on the New York, American and other exchanges (963-964). Dackerman is a member of the New York Stock

Exchange, the PBW, the Pacific Coast Stock Exchange, and the American Stock Exchange. [Footnote: It is also a member of Pittsburgh Stock Exchange but did not mention this in testimony.] It became a member of the Pacific Coast Stock Exchange in 1964, and a full member of the Amex in 1963. Harry C. Dackerman has the seat on the New York Stock Exchange. The firm has 7 brokers on the PBW Stock Exchange; it does not have any floor brokers on the American and New York Stock Exchange (965). On the New York Stock Exchange, most of the firm's orders are executed through Laird Bissel & Meed or Drexel and Company. Dackerman also uses independent floor brokers on the NYSE and Amex for certain transactions which it clears by mail. The firm's current correspondent rate with Laird Bissel for executions on the NYSE is 21%, and its rate is close to the minimum on the Amex (965). Sixty-four per cent of Dackerman's PBW commissions come from its activities as floor broker on the PBW for sole members. This commission business represents 15% of the firm's total commissions from all exchanges (966). If a Philadelphia member wants to buy a security which is traded on the PBW, Dackerman executes the order for him and charges him 10% floor brokerage. All of these members of the PBW belong to the Clearing Corporation (966). Most of the stocks in which Dackerman trades are dually listed (967). (Approximately 700 securities are listed or traded on the PBW (967)). In the year 1967, the firm's profit from its activity as a specialist (i.e. its purchases and sales as dealer for its own account) was a major portion of its net income (968).

In relation to the firm's specialist activities, odd-lot transactions are automatically filled on the basis of the first sale after three minutes in New York. Round-lots are executed in line either with the New York bid and offer or with the last New York sale. The odd-lot/round-lot dealer is not obligated to take round-lot orders; he is obligated only to fill all odd-lots. If his position or judgment so determines, he may make a round-lot bid in line with the New York bid, but at all times he will be within the New York bid or offer, so it is impossible on the PBW ever to establish a new high or a new low (969). If $50 is the last PBW sale of a dually listed stock and an order comes in to sell a round-lot at that time, the New York market might only be 49 7/8 to 50. The PBW customer will get a report, "You have sold 100 at 49 7/8 with an adjustment." If the stock never sells below 50 at the end of the day in New York, the price of the customer will be adjusted to 50 to the customer's advantage (969-970).

The firm will take round-lots to New York both in its specialty stocks and in its other securities (970); it telephones orders to Laird's New York office directly from the Dackerman post on the PBW. Dackerman instructs Laird to execute the order either on the New York or the American Stock Exchange depending on which is the primary market (970). Dackerman is then charged the rate normally charged correspondents (971). The customer who is a non-member of the New

York Stock Exchange is then charged the full New York Stock Exchange commission. (971).

The firm gets very little business from individuals: in the first six months of 1968, it represented a little over 2% of total commission income (972). In 1967, 24% of the firm's commission income came from mutual fund full commissions and 54% came from sole PBW members (odd-lot dealers and floor traders) on the New York and American Stock Exchanges (973). Where Dackerman executes an order with Laird Bissel for a sole member, the sole member is billed by Dackerman through a confirmation which charges him a full commission, but if the sole member has a public customer, that member will receive reciprocal clearances from Dackerman on the floor of the Philadelphia Exchange (974). Dackerman's only method of reciprocation to sole members is reciprocal clearance (986). Suppose, for example, the sole member is billed a total of $200 in commissions by Dackerman. Then eventually during the course of Dackerman's essentially principal trading, Dackerman will have that member clear for Dackerman, on the floor of the PBW, transactions on which the gross commission might be approximately $200. The sole member receives 50% of the gross commission (975).

Dackerman buys and sells for its own account as specialist on the PBW dealing with a wide range of broker-dealers. These dealer-trades will take place at prices related to the primary New York market. Every trade on the PBW has to have a broker's name on the buy side and a broker's name on the sell side. Thus if Bache comes in to sell 100 shares of General Motors, Bache's name will be on the sell side of the order ticket. Suppose Dackerman was buying the order for its own account. Rather than using its own name, it will put the name of another firm, one that has previously given Dackerman business to execute on the NYSE (978). on the ticket (977). Since the transaction ticket is processed through the clearing corporation, Bache will get one side of the ticket indicating that it is the seller, and the Dackerman-named firm will get the other side of the ticket indicating that it is the buyer. In addition another ticket is put through the clearing house showing that the named firm will deliver the stock to Dackerman. The named firm is in-and-out; the stock starts at Bache and winds up with Dackerman (977-978).

Bache still has the responsibility for obtaining the securities and for delivering them to the Stock Clearing Corporation. Stock Clearing Corporation records show that Dackerman-named sole member is the buyer of the securities and that he receives the certificates. In fact, he never receives them. There is an immediate reversing entry which indicates that he delivered them to Dackerman. The clearing corporation records reflect that Bache delivered to Firm X, sole member, which it does not; and then that X delivers to Dackerman, which it does not (979). The purpose and effect of this procedure is to generate dollars for the sole member (979). When transactions are executed on the PBW the Stock Clearing Corporation has the responsibility for the payment. Mr. Waber stated that in his experience in the last 30 years, the Stock Clearing Company assumes no real risk. One way to look at it is that sole member is charging Dackerman 1/2 of the gross commission for using the sole member's name on the ticket (980). In effect, Dackerman is absorbing this expense to reciprocate for the order it executed on New York (981). Dackerman does this same thing on specialist trades, even though there is no commission on the specialist-dealer trades. Waber states that whatever his firm is doing in the area of reciprocal business, it is strictly within the guidelines of the Toronto agreement (discussed in the Special Study) between the New York Stock Exchange and the regional stock exchanges. At this meeting the understanding was that the maximum rate for clearance give-ups was maybe 50% [Footnote: The witness really meant to say minimum clearance fee must be 50% on clearance give-ups.] (981 -982).

Mr. Waber stated that this reciprocal business is a matter of extreme importance to the sole member of the regional exchange. The reciprocal business makes it possible for a small broker, wherever situated, with a nominal amount of capital, to have access to the primary markets. Without that access, he could not compete with the wire houses that are situated in his own community. Moreover, the reciprocal business is a means of directing to the PBW odd-lots and round-lots; it thus provide competition for the odd-lot/round-lot houses and the specialists in New York (983). A professional discount would not bring a flow of odd-lot and round-lot orders from dual stock exchange members to the regional exchanges. Dual members tend to direct all of this business to a few New York houses (984). PBW members who are floor traders and odd-lot dealer specialists execute orders on the New York Stock Exchange in order to cut down their positions. Thus, some retail orders which come in to the dealers on the floor of the PBW are offset through the primary market in New York.

In 1967, Dackerman executed orders of this nature in the amount of $325,000 on New York, either offsetting or creating new positions (New York specialists do not offset on the regional exchanges) (985-986).

When Dackerman gets a mutual fund order on the PBW with instructions to complete the order right away, Dackerman will go to the dealer in the stock to let him take what part of the order he may want. Dackerman may or may not position part of the remaining order himself; he puts the rest on the New York Stock Exchange (987). An average of about 20% of a 10,000 share order will be taken in Philadelphia either through the specialist or through the specialist and Dackerman (988). Of the mutual fund orders that Dackerman receives, exclusive of crosses, about 50% (1012) are executed on Philadelphia and the other 50% on New York. The entire mutual fund order will be filled on the PBW 50% of the time. The remainder of the orders average a 20% fill ratio.

Waber states that it is very rare for Dackerman to have both sides of an order (989). It does not handle mirror or transported trades (990). Crosses are of such minor importance that Dackerman usually has to execute either on the floor of New York or the PBW (991). Dackerman will not buy the security as principal for its own account from the fund and sell it simultaneously on the New York Stock Exchange. If Dackerman does have both sides to a cross, it will not buy from the seller on one exchange and sell to the buyer on the PBW (991). Dackerman rarely gives up to an NASD member or to a PBW member, only once or twice in the past year at the direction of a fund (993). If a fund directs a give-up to a sole PBW member, Dackerman, as a floor broker, acts as if the order had come from the sole PBW member rather than from the fund directly. The result is that Dackerman gets no commission directly from the fund. The broker of record (i.e. the sole PBW member who bills the fund and receives and pays for the security) gets 100% from the fund and remits floor brokerage to Dackerman. It is Dackerman, however, who executes the order and communicates with the fund, obtaining instructions, for example, as to whether it is a limit order or a market order. Dackerman is constantly transmitting and receiving information with the fund trading department. Dackerman neither sends nor receives any confirmation on the trade; its books show only that it billed the sole PBW member for floor brokerage (996). Dackerman, which considers itself specialized and expert in this activity, uses three floor people to do this work (994-995).

Dackerman looks at this transaction, where it gets floor brokerage only, as a team transaction. Dackerman is doing nothing for the fund that it would not do for a sole member who used it as a floor broker. Dackerman considers that the sole members have contributed something to the transactions; it was through their courtesy that Dackerman got the order (997-998).

On the other hand, if a fund came to Dackerman with directions to execute an order and send a give-up check to a sole member for 70% or 90%, Dackerman would not do it, because the rules of the PBW set a ceiling of 65% on a give-up check. Dackerman would send 50% but never 90%, even if the rules of the PBW were changed (1000-1001).

As noted above, when Dackerman executes for a customer on the PBW, it is done with an adjustment (at the end of the day, sale prices exceeding New York's highest or lowest prices are changed) (1003). If the sale is for a fund, however, and the sale price is away from the New York Stock Exchange bid-ask range, Dackerman will not give the fund an automatic readjustment without first checking with the fund and getting proper instructions (1003-1004).

Except for the mutual fund give-up business and the clearance of transactions for the introduced accounts of some PBW odd-lot dealers and floor traders

Dackerman does not act as floor broker or clearing firm for trades by sole members executed on the PBW. On its PBW clearance business Dackerman collects 100% of the commission and gives the floor trader or odd-lot dealer 50% of the reciprocal. When Laird Bissell provides the executing and clearing functions for Dackerman, it charges Dackerman 21% of the commission. Laird Bissell does not bill the customer, it bills Dackerman only (1007-1008).

In 1967, PBW sole members gave Dackerman $405,915 worth of floor brokerage which is derived from mutual fund executions (1009). Of the 50% of mutual fund orders which are executed on the PBW, approximately 20% to 25% may be purchased by Dackerman as principal. The other part might be absorbed by the specialist, by commission brokers such as Jefferies and Company, by an institutional broker who has the other side of the cross, or by a house like Butcher & Sherrerd, which has a big public business (1009-1010).

Dackerman's average combined position as a specialist for all of the 115 stocks that it specializes in is over 300,000 shares, representing approximately $6 million. Of the 115 securities, Dackerman may have positions in only 1/2 of them; the maximum position would be 10,000 shares (1013). Dackerman's positions are probably the largest of any specialist on the PBW (1013).

Where the order of the fund is executed on the New York Stock Exchange rather than the PBW, the commissions cannot be shared with persons who are not members of the New York Stock Exchange. In this connection, Dackerman eventually will ask the other brokers to clear transactions for Dackerman on the floor of the PBW. These transactions, basically Dackerman's specialist trades, are totally unrelated to those the fund placed originally (1014).

"Courtesy broker" is defined as the person or broker who is to get the reciprocal clearance (1015). Dackerman started getting fund business through members of the PBW who were selling fund shares and suggested to the fund that Dackerman be given an opportunity to execute some of their orders (1015). Dackerman has been instrumental in obtaining new members for the PBW by advising them as to how this method could be used to reciprocate for funds sales (1016). Sole members look to the PBW primarily as a place where they can get executions for 10070 of the commission. Secondarily, they look to the PBW as a means of recouping a substantial part of the commissions for which they are billed for transactions executed on the New York or American Stock Exchanges (1016). The firms of Hardy and Hardy and Raymond James are frequently named as either stock record brokers or courtesy brokers by Dackerman. The dollars which are distributed to these two firms at the direction of funds through these two techniques exceed their round-lot purchases and sales on the PBW for their customers (1017). Mr. Waber stated that while these members may be using their membership on the PBW to sell fund shares, there are other members who are not. The dollars distributed to the firms of Raymond James and of Hardy, Hardy at the direction of mutual funds exceeds their purchases and sales for their customers on the PBW (1017). This helps broaden the PBW market to the extent that Dackerman does a substantial amount of business on the PBW. Even if a dealer-specialist buys the shares, PBW may benefit because the dealer-specialist may later be able to supply the shares to a small PBW broker who will not then have to go to the New York Stock Exchange (1019).

Specialist Activity

Commission Exhibit 85 was reserved for Dackerman & Co.'s "at risk" purchases, for its own account in its specialty stocks, from mutual funds in each of the last six months (1019). Dackerman bought 522,000 shares and sold 546,000 shares as specialist on the PBW during the month of June, 1968. On the New York Stock Exchange, Dackerman bought 24,000 shares and sold 146,000. In May, Dackerman bought 480,000 shares and sold 448,000 shares on the PBW. On the New York Stock Exchange, Dackerman bought 44,000 shares and sold 125,000 shares. In April, Dackerman bought 450,000 shares and sold 418,000 shares on the Philadelphia. In New York, Dackerman bought 52,000 shares and sold 104,000 shares (1020). Commission Exhibit No. 86 is a document entitled "Total Income from Commissions and Floor Brokerage, Part I, and Direct Execution Expense, Part II" (1021). This document refers to mutual fund orders executed for PBW members; and it shows stock of record for transactions in which there is no clearing expense (1022). The document also refers to "stock of broker," i.e., stock of Raymond James.

Dackerman also block positions. In this connection, if an order comes in for 20,000 shares and Dackerman is not the specialist or the odd-lot dealer, the specialist may take, say, 5,000 shares, Dackerman will get perhaps ten thousand more shares covered, and then Dackerman will clean up the other 5,000 as principal. In effect, then, Dackerman is block positioning. However, it gives up in someone's name 100% of what a commission would have been if this had been an agency transaction (1023-1024). If a stock is trading at 50 Dackerman will not sell it at 49-1/2 to his customer (the equivalent of what he in effect gives away through a give-up on this dealer trade). Dackerman does not do this because it wants its trading department and commission department to each stand on its own legs (1025). In this connection, the charges that are paid out to courtesy brokers are charged against commissions, not against trading. If Dackerman were not a specialist on the PBW and did not have trades against which to name clearing brokers, it could not perform the function it is now performing (1026). In other words, Dackerman's specialist activities create a dealer trade to which Dackerman can ascribe a commission (1026). This commission is then used to meet Dackerman's reciprocal obligations to fund customers and to sole members. Mr. Waber stated that reciprocal business serves a very important function for the PBW, and that while it is a cumbersome system, it is accomplishing the things that it should be: it is directing business to the PBW and it is bringing odd-lots (and round-lots) there, helping to break up the NYSE odd-lot dealer monopoly. Mr. Waber said that there is no reason to change the system.

Mr. Waber described Dackerman's trading activity some years ago in Occidental Petroleum (1030). Dackerman received an indication from a fund that the fund was interested in buying Occidental Petroleum at a limit of 45. On the PBW, Dackerman had the opportunity to buy 5,000 shares at 45 1/8. It bought the stock as principal at 45 1/8, and then called and told the fund that it had purchased at 45 1/8 and that the fund could purchase from Dackerman at the same price. During this time, the stock moved up to 45 1/4 or 45 3/8: The fund did buy the stock.

When Dackerman bought the stock, it had another member of the PBW clear the 5,000 shares. It then paid the PBW member reciprocal clearance for commissions that Dackerman had previously received from that broker's business or on fund business. Similarly, when Dackerman sold the stock to the fund customer, it gave up another broker's name for clearance and paid clearances on that side. By dividing the single trade into two distinct parts, i.e., two principal trades, Dackerman multiplied the full commission paid out by two. On this trade, one party was a member of the PBW and the other party (i.e., the fund buyer) was not a member (1030-1032).

Commission Exhibit No. 87 is a document entitled "First Six Months of Fiscal 1968, November 1, 1967 through April 30, 1968." This exhibit shows the commissions which Dackerman received and billed directly to two funds during the first six months of the fiscal year 1968. It shows the exchange on which the order was executed and indicates the number of give-ups checks sent to PBW sole members and to NASD members. It also shows the number and the amount of the clearances that Dackerman has given to courtesy brokers against these particular transactions. With respect to the top ten fund customers, Dackerman received total direct commissions of approximately $266,500 on the New York Stock Exchange and $14,602 on the PBW. The difference in these amounts is due to the fact that on the PBW, Dackerman is acting only as a floor broker; the fund names the broker of record. So Dackerman receives only floor brokerages from the fund (1033-1034).

Dackerman is an associate member of the Boston Stock Exchange. Before taking an order to New York, Dackerman will go to the Boston wire and check to see whether or not a Boston dealer wants any part of that order. The usual reply is for a small part. Boston reciprocates in the same manner, and the PBW response is also usually small (1035-1036).

For the first six months of fiscal 1968, Dackerman received approximately $291,000 in commissions and paid out $121,830 in clearances in its trading as specialist. This income exceeds Dackerman's retail agency income on the PBW (1034-1035).

A. G. BECKER & COMPANY
July 15, 1968 -- pp. 1041-1122

Background

A. G. Becker Inc. (Becker) is a corporation with 66 voting shareholders (1040) with principal offices in New York and Chicago. The firm is a member of the New York Stock Exchange, the American Stock Exchange, as well as the Midwest, Pacific Coast, Detroit, Boston and PBW Stock Exchanges. The firm serves as a specialist on the Midwest and Pacific Coast Stock Exchanges in a total of 134 stocks. Between the two regional exchanges, only 12 of these stocks are common to each other. The firm has floor brokers on the New York, American, Midwest, and Pacific Coast Stock Exchanges, with four floor brokers on the New York, three on the American, four on the Midwest, and four on the Pacific (1041-1042). The floor brokers on the New York Stock Exchange do not act as $2 brokers for other firms, but only handle A. G. Becker business. The firm's gross income is broken down as follows: retail sales, which is mostly individual accounts in medium to small sized institutions, amount to 40%; institutional sales produces 15%; gross income in connection with various exchange operations yields 25%; corporate banking and commercial paper, 13%; syndicate and municipal bonds trading, 8%. The firm's exchange activities include its dealer activities as specialists and its floor brokerage income (1044). It also includes acting as a correspondent for members of the PCSE and the MSE for their trades on these exchanges and on the NYSE.

Correspondent Business

A. G. Becker defines correspondent as a member firm for whom they clear. They are a correspondent for only one firm on the New York Stock Exchange. When Becker acts as a floor broker for dual or sole members of the Midwest, Becker executes as a professional floor broker only. The Midwest member then must clear for themselves by mail (1045). Floor brokerage costs approximately 10%, and clearing costs 3% (1046). This same arrangement is true for the Pacific Coast Stock Exchange. There is only one firm on the Pacific Coast for whom Becker clears in addition to acting as floor broker (1046).

Midwest Executions

On the Midwest Stock Exchange, Becker & Co. performs the function of being a broker's broker for sole members of that exchange. They see their primary function as competitively executing a sole member's order on the Midwest when possible, and if not, sending it on to the primary market (1048). On an order of a multiple number of round lots, Becker very often will split the order between the primary market and Midwest. The primary market order will be executed first and then the order on Midwest will be executed at the same price as in the primary market. On a 100 share order, many times the broker is given a stop on Midwest, which means that he is guaranteed of getting a specific price. The order then is sent on to New York on a fill or kill basis, which means that if New York can beat that Midwest price, it will be executed on New York, and if not, the order will be killed and he will get the Midwest execution. At pages 1050 to 1053, there is a discussion of the problems that are attendant to executing off a New York tape, which only indicates the last sale, and does not indicate whether that was a bid or an offer. It is the regional's contention that because of this, many times, better execution can be had on the Midwest that could have been had on the New York. It is also a problem, as discussed on page 1053, that all executions on the regional must be within the range of the execution for the day on New York, or the customer will think something is wrong when he looks at the New York prices in the newspaper. (This is so, even though the "out of range" execution may be legitimate.) Backer's costs are the same no matter which exchange the order is executed on, although there are differences if the order is executed on a split basis. Normally, when the order is sent to New York, it is sent in as a market order, and therefore is executed, it is a buy on the offering side of the market.

Reciprocals

As Becker must charge the Midwest-only member a full non-member commission for orders executed on the New York Stock Exchange, they use specialist give-up on Midwest to make the execution economically viable for the sole member of MSE, whose customer's order has been executed on NYSE. In addition to the specialist give-up, where necessary they also give-up on trades that they execute on Midwest for their own retail customers. Both of these methods involve naming the Midwest sole member as a clearing broker on the Midwest trade, which may or may not be related to the execution on New York. The Midwest only member then receives 50% for clearance. His expenses out of this are approximately the actual clearance charge of 3% plus 10% floor brokerage. Becker reciprocates on a 2 for 1 basis, meaning they give back $50 in give-ups for every $100 worth of commissions they get for the New York trades. The net result is that the Midwest broker gets back approximately 37% or 38% of every commission dollar that is placed on New York (1062). It makes no difference to the firm whether they use the specialist give-up or the retail trade give-up. For the first ten months of 1967, A. G. Becker paid out $1,141,000 to other brokers by naming them as the clearing firm. Most of this was on specialist trades. The witness then explained that as far as Becker is concerned, the amount that they have to give-up to a Midwest broker for an earlier trade in no way effects the price which the later trade on Midwest is executed. The cost of giving up on a specialist trade are attached to the earlier trade and not to the specialist operations (1070). Even with this in mind, the witness maintained that the give-up was not a rebate of the New York Stock Exchange commission but an overall reciprocal relationship. Becker feels that this type of reciprocal practice creates a necessity for specialist trading to continue on the regionals, and therefore it gives more competition to the specialists on the primary market. Too, it relieves some pressure on that specialist.

Becker feels that it is reluctant to have reciprocal arrangements with broker-dealers who are not regulated by the exchange because they do not feel that the NASD regulation provides them with sufficient protection to deal with a broker who will continually owe them money and owe them securities. They do admit that there are some firms to which this would not apply. They also maintain that there have been times when they have refused to enter into a reciprocal relationship with brokers who they would not feel comfortable doing business with. Becker feels that if there is some type of professional discount for NASD members, there ought to be enough differential so that it will not discourage people from joining in the regional exchanges (1077). They differentiate between entering into reciprocal relationships with NASD dealers where the dealer will be owing Becker money or securities and sending them give-ups on the Detroit Stock Exchange, where only Becker will be owing money to the NASD dealer (1081). They would not have to worry about the financial responsibility of the NASD dealer in that case.

<u>I.D.S. and Kansas City Reciprocals on PCSE</u>

When using the specialist give-up on the Pacific Coast Stock Exchange, they use a 3 for 2 ratio, Becker's primary function in this operation is to get money to the Pacific Coast broker-dealers who are affiliated with mutual funds, Kansas City, IDS, Plaza Securities, Imperial Financial Services (1087). In the IDS case, they are merely a conduit to get money to IDSS (the Pacific Coast member subsidiary) by receiving a give-up check on the New York Stock Exchange from a New York member and then passing it on to IDSS on Pacific Coast. Becker's profit for playing banker in this transaction is 33% of the dollars which it receives on New York (1091). It is no concern at all of Becker's what these four investment advisers do with the money that they receive. When Becker gives away dollars on Detroit to NASD dealers, he similarly does not care what they do with the money. On page 1093, Becker said that the fact that the money is going back to the shareholders in the form of a reduced advisory fee, is not a situation that would cause Becker to reject the reciprocal relationship.

The four-way ticket of Pacific Coast is the primary method of getting those dollars to the recipient brokers. The names appearing on this ticket are those of both the buyer and seller (designated as receiving and delivering brokers on the ticket). and a "clearing member" named by each. The latter brokers have nothing at all to do with the transaction and merely receive cash by virtue of having their names on the four-way comparison ticket.

Effects of Reciprocal on Other Aspects of Business

Becker testified on 1095 that these reciprocal relationships give them and others like them incentives to continue their specialist operations on regionals or exchanges, and if they feel these specialist transactions are helpful to the general liquidity of the market, They feel that over-the-counter agency trade is not quite the same as the specialist-dealer trade and that they would not feel comfortable giving up on the trade. Becker said that it would not engage in the underwriting give-up, because it might sway its judgement on what was best for their customers to buy and lead them to underwrite stocks which they ordinarily would not make. They say this does not happen in a specialist situation, even though there are no competing specialists on the Midwest. They feel that the New York Stock Exchange tape provides a measure of protection for everybody concerned when they are using a specialist give-up (1101). They feel that their specialist activities makes for a tighter market because of the reciprocal obligations. Becker executes most of its odd-lots on the New York Stock Exchange and does not give-up on odd-lots.

Regional Specialists

Specialists on a regional do not have to take every order that is presented to them as they do on New York. On Midwest, at least one side of the market must be competitive with New York, and usually both sides are competitive. The witness illustrated this in his testimony on 1057 and also attempted to show how the Midwest specialist relieves some of the pressure on New York. It is also apparent, however, that there are times by using the regional, an order might gain in priority over what is already on the New York Book. At the present time, over the course of a year, the average position, both long and short that Becker maintains in its specialist stock, on the Midwest Stock Exchange is $3 million and on Pacific Coast, about $1 3/4 million. On some occasions, however, it will run even higher than this. Exhibit No. 88, identified on page 1109, shows that Becker & Company offsets between 40% and 50% each, on purchases and sales on the New York Stock Exchange. At page 1109, Becker says that 95% of their transactions are limit orders left with the specialist, and therefore these generally are stabilizing transactions and they are helping liquidity in the market. The reason is that if they are limit orders to sell the price has to be going up to reach it and to buy, it has to be going down to reach it. When offsetting on New York, Becker only uses day limit orders. When you take an order off of New York at the end of a day, you lose your priority to other customers. Becker makes a gross trading profit in specialist stocks. When Becker is the specialist in a stock on the Midwest which one of its retail customers wants to trade, it is company policy that the specialist will give the stop on the Midwest and then automatically send the customer's order on a fill or kill basis to the primary market. The only exception to this is on split orders when the order will go to the primary market anyway (1064).

Institutional Business

The orders that are brought to Pacific Coast to satisfy reciprocal obligations to IDS and Kansas City, in addition to the specialist give-up, are mainly crosses. In these cases, it really doesn't matter where the order is executed if you do not consider what may be on the book in New York. Almost all of the crosses that Becker does are institutional crosses. Becker does block position and does not give up on block positioning trades. This is because they need the additional commission dollars to try to break even on the transaction in which they are at risk. They give-up on specialist trades, however, when they are at risk because the income offset has already come in and this really does not affect the specialist trade at all.

For the most part, Becker uses a give-up by check rather than a clearance give-up when giving up at the direction of mutual funds. Gross commissions paid by mutual funds to Becker in 1967 were approximately $2 million About 50% of that was given up by checks (1115). Backer's business for institutions is very substantially that of a lead broker, although it does do much cross business. They find that business to be profitable, although they do give-up 50% of their commissions. Becker said that it would be fair to say that their large accounts subsidized their small accounts, although they have not done a cost allocation study.

A recent study indicates that Becker executes 20% of its institutional crosses on New York, Midwest, Pacific and Philadelphia and 10% on Boston, 1% on Detroit, 1% on the Amex, and 8% over-the-counter. Many times Becker will bring its cross to a regional exchange so that the specialist or the book on New York will not break it up. This is true, even though if the cross is broken up, the customer might be able to get a better price. Becker says that it is their experience that sometimes if a customer cannot get the full amount of shares that he desires, he will not be interested in buying any shares. This would apply even to the point of taking 9,200 shares instead of 10,000. They also testified that they could not supply stock because crosses are usually done on a down-tick and this would be an illegal short sale. The reason for the consistent down-tick is that buyers want to buy at a discount, sellers will usually take a minor discount to move a large block of stock (1085). Becker testified that if a NASD member is an investment adviser to a mutual fund, they would give-up to him at his own direction. They would not care what the investment adviser does with the give-ups he receives.

<u>RALPH W. DAVIS & CO.</u>
<u>July 15, 1968 -- pp. 1122-1214</u>

Mr. Scott Davis, Senior and Managing Partner of Ralph W. Davis and Company of Chicago (Davis) testified. Davis is a member of the New York and Midwest Stock Exchanges. Through its activities as a specialist on the Midwest, it provides access to the NYSE for Midwest-only members (1161). Six partners are members of the Midwest Stock Exchange; five are on the floor, and one is an operations partner in the office. The firm is a specialist in 13 dually-listed and one solely listed issue on the Midwest Stock Exchange, including General Motors, General Electric, American Telephone and Telegraph, and United States Steel (1123). Davis attempts to see that its capitalization will support a minimum position of $2 million in its specialty stocks. Aside from its specialist activity, it considers itself primarily a broker's broker on the Midwest and New York Stock Exchanges. (Actually on orders for securities solely listed on the New York Stock Exchange he acts merely as a conduit in sending his customers orders on to the NYSE.) It also handles the execution of orders on other markets, such as Amex and PCSE, for certain Midwest member firms. It handles a small number of transactions on Amex, PCSE, and NYSE for several banks. At one time in the past, Davis handled quite a bit of business for Fidelity Fund (1125), but at present handles no direct business for them, but is merely a conduit for their give-up checks.

The firm does not employ salesmen or registered representatives, and does not solicit or handle public retail accounts. In the last year, Davis paid to its New York correspondents $332,000 on customer business and $200,000 for its own business. Davis does not sell mutual fund shares, does not block position, and generally will not communicate directly with institutions; its primary customers are other brokerage firms.

Davis is not an underwriter. Its name has never been given up as a soliciting dealer in a tender offer by an investment company. It does not make over-the-counter markets. Its odd-lot orders are executed on Midwest whenever possible, and it does act as broker's broker for odd-lots from out-of-town firms (it does not give-up on odd-lots). Davis is not a member of the American Stock Exchange; it executes business there through a correspondent, Rauscher Pierce Securities Corporation of Dallas. Dishy Easton & Company was a correspondent in the past, but no longer is in that capacity.

Davis' gross income for the year ending March 31, 1968 was $3,323,324.26 (1129). Slightly less than 25% of this was gross profit from its own trading; the balance was received for executions. Forty-seven percent of Davis' gross income was received from Midwest firms for executions on the NYSE. All of its broker customers on the Midwest clear their own trades (Midwest has a clearing by mail operation) (1132). The largest operating expense was $954,000 paid to MSE member firms for clearance of transactions (rather than a clearing charge, this is actually the reciprocal payment from Davis to the Midwest-only member who placed New York business with him). The second largest expense was approximately $500,000 paid to correspondent brokers for execution on the NYSE (Davis' correspondent rate is slightly more than 21%). Most of Davis's orders are transmitted by telephone or by private wire teletype directly to the Midwest floor and are immediately handed to one of the floor partners (1135). After trying to ascertain the market both on Midwest and New York (and sometimes on the PCSE, although Davis is a non-member and does not receive reciprocity for orders executed there) "then the broker will make his own judgement decision as to how he will enter the market place on Midwest; whether he will buy at the offering; whether he will bid at a lower price; whether he will attempt to attain a stop or guarantee of execution and then enter the order on a primary market at a different price, in order to try to obtain the best overall price of execution for the customer" (1136). The bid/ask from the NYSE is presently not available to Davis on the floor of the Midwest. It would be possible to receive the quotes in Davis' office (which is several floors above the Chicago trading floor) through utilization of an interrogation unit, however policy of the NYSE Board of Governors bars this; thus Davis must used a leased line from New York and get current information by telephone.

Davis' transactions fall into a discernible pattern: A Midwest-only broker-dealer gives an order to Davis who passes it on to Pershing & Co. for execution on the NYSE. If the order is to be executed on the Midwest Exchange the Midwest-only member passes that order on to Davis for its execution. Davis estimates that on orders of less than 500 shares it does approximately 75% of its share volume executions on the Midwest, Davis' customer firm sends the confirmation to its customer because the MSE-only member is a clearing member of Midwest. On an order sent to New York, Davis receives a report from Pershing and confirms to the Midwest broker who, in turn, confirms to his customer. On a split order, the Midwest-only member confirms the portion that is executed on the Midwest, and Davis confirms to the Midwest broker the portion executed on New York. Immediately following the execution of an NYSE order, Davis has received one full commission from the Midwest-only member and has paid out approximately

21% to Pershing retaining 79% at this point. The Midwest-only member has received one full commission and paid out one full commission; he has not made any money.

The Midwest member will receive money through a reciprocal agreement on a later transaction on the Midwest Stock Exchange (1146). The reciprocity that is described below takes place on specialist trades on the Midwest. However, the reciprocal part of that trade would never take place if there had been no trade in New York, although the trade would take place anyway (1147). At the time Davis makes one of its specialist trades on the Midwest, it gives up the name (i.e., substitutes another name for its own name on the comparison ticket) of the broker to whom it wishes to reciprocate. The witness pointed out that "it makes absolutely no difference in the trading or the pricing mechanism effecting the trade." The substituted firm then becomes the clearing firm on the transaction. It pays the clearing corporation charges and, as a matter of mechanics in reporting to the exchange it is on the books as the clearing member. The substituted firm then charges Davis 50% of the non-member rate for clearance; pays Davis for floor brokerage; and ends up receiving net, about 40% of the original NYSE commission (less expenses) it paid to Davis. Davis would normally have to pay 1% to 3% (instead of 40%) to get that trade cleared. The net cost to the Midwest-only member is as if it had a 40% discount in placing the order on the Midwest. (1154-1156)

The "giving up of a name" is actually placing another firm's name on the execution ticket -- normally a firm which had nothing to do with the actual specialist trade. This firm guarantees the trades undertaking that its agents at the Midwest Clearing Corporation will physically move the securities (i.e., receive or deliver them); since the Midwest Clearing Corporation is a clear-by-mail operation, however, this firm actually never sees the securities. The clearing cost, i.e., clearance, is handled by the firm itself without giving up a name, is less than 3% of the commission (1155). Sometimes a firm does have an overnight liability for the use of funds and for its guarantee of the trade (1156). The firm whose name is given up is not reimbursed for any extraordinary expenses, however, the necessity of paying such a charge is very rare (1159). The total profit to Davis on the transaction executed in New York can be calculated as follows: from the 100% that Davis receives, Pershing gets 21%, the clearing member is given 40% and therefore Davis gets 39% plus saving any small clearing cost that it might have had to pay on the specialist trade (1160). The specialist trade is the key to this method of providing access for the Midwest-only members to New York (1161).

The witness said "I might also state that at no time has the firm of Pershing and Company, nor ourselves, negotiated on this particular rate [21% for execution and clearance on the NYSE]. I have not gone to them and said that I think it should be lower; nor have they come to me and said it should be higher. This is the rate that they offer and we have deliberately selected them. I believe we would be doing business with that firm if they were charging 25%, 26% or 28%."

Rauscher Pierce, a correspondent of Davis, gives up to Davis on either NYSE or Midwest trades. On the Midwest, Davis clears for the correspondent and charges the clearance rate (1168). When Dishy Easton (a non-member of New York) was executing orders for Davis on the American Stock Exchange, Davis would execute for Dishy either on New York (through its correspondent) or on Midwest, and would then charge Dishy the full non-member rate. Commission dollars similarly are returned to Davis from the Amex.

Institutional Business

Davis has handled executions and give-ups for institutional customers; the Fidelity Fund group is one such customer. Some time ago, Fidelity used to give orders directly to Davis, but that method has changed. Now, Fidelity gives the orders directly to Pershing; Pershing executes the trade as if it were Davis' correspondent. Davis explains that he found "for reasons of efficiency and service and expediency in handling the order there would be occasions when, by calling us in Chicago, we would then have to, in turn, contact our correspondent firm, Pershing & Company in New York in order to even begin the process of executing the order" (1174). Davis then instructed Fidelity to call Pershing directly. This is similar to Pershing getting the order and giving up 79% to Davis to re-distribute among other members of the Midwest (Fidelity also sometimes executes orders on the Midwest and has Davis named as a clearing broker). The use of this arrangement has declined rapidly; it now generates less than 2% of Davis' gross income.

Davis takes responsibility for these trades just as if it had initiated them. On trades where Davis has confirmed orders on Midwest, and has given up to other Midwest brokers, the confirmation goes directly from Davis to Fidelity as if the trade had initiated with Davis. Davis has never executed trades for Fidelity as floor broker. The orders come to Davis primarily through Jablonski & Company (1176). Exhibits 92, 93 and 94 show various bookkeeping summaries of how Davis & Company distributes give-ups; the Fidelity Funds are listed separately. The word "check" in the exhibits may connote more than its normal usage; it may mean "clearance" give-up. Clearance give-ups are used where the recipient has to pay floor brokerage back to Davis. Davis makes sure that the net figure equals the amount that Fidelity owes that broker. The witness could not explain three large give-up checks back to sole New York members (1180), stating it would not be normal for Davis to do this.

On Fidelity Fund business executed on Midwest, Davis gives-up 70% of the commission, paying 10% floor brokerage and retaining approximately 20% as compensation for the expense of receiving and paying out the money. On New York Davis gives-up 58%, paying Pershing 21% and retaining the same 20%.

When a bank wants to reciprocate to a Midwest-only member, it calls Davis directly and instructs Davis to execute the order on Midwest giving up the Midwest-only member's name. The correspondent relationship seems to be a fiction; it is actually a straight give-up with either Pershing or Davis executing the orders, then giving up to another member of a designated exchange.

In 1967, Davis received a check from Shearson Hammill & Co. in the amount of $5,000. They did not know the circumstances upon which they received this check. Exhibit 91-A has been reserved for an explanation of this check (1172).

MITCHUM, JONES & TEMPLETON, INC.
Testimony July 16, 1968 -- pp. 1218-1309

Introduction

This firm is a leading member of the Pacific Coast Stock Exchange ("PCSE") and was called primarily in relation to the 4-way ticket employed on that Exchange, particularly the specialist giveup on the 4-way ticket. Among the representatives of the firm at this hearing were Richard Jones, the firm's President, who is also Chairman of the Board of Governors of the PCSE and Messrs. Calin and Shropshire, PCSE specialists.

Mitchum, Jones & Templeton ("MJT") is a California based firm with 16 offices in California, one each in Nevada and Arizona, and a New York office to handle executions and clearing (1219). Commission income in 1967 was about $10 million, distributed among various exchanges as described in the testimony (1224). MJT is a member of the New York, American, Pacific Coast, Midwest and Boston Stock Exchanges, with members on the floor of the NYSE (1), Amex (1), and PCSE (5) (1219). They use three floor brokers on Midwest, they use Cantella as floor broker on Boston (1222). and make extensive use of other floor brokers on NYSE and Amex (1227). The firm has five specialist posts on the PCSE, involving 150 issues (1220). MJT is a clearing member on all five of these exchanges (1219). Other aspects of the firm's business were also mentioned, including research (1219), underwriting (1219), investment advisory services (1220), municipal bonds (1220), and mutual fund sales (1220, 1228). The OTC business (1224-1225) and correspondent operations were described briefly

(1226-1227). The witness was also asked to describe various aspects of the operation of the PCSE. The nature of the dual markets on that exchange was examined, with particular emphasis on the extent to which dual specialists are used (1220-1222).

Institutional Business

MJT handles both individual and institutional accounts, with 40% of its commissions coming from institutions and 60%, from other customers (1225). Mutual funds account for 70% of the institutional total with the remainder divided among various other types of institutions. The staff submitted, as Exhibit 97, a table detailing for 12 fund complexes, by exchange, the commissions earned and the giveups received and paid out, as well as the dealer concessions earned for sales of fund shares (1229).

The witnesses were asked the reasons for differences in figures between the various funds. They were asked why MJT received orders for execution from some funds and only received give-ups from others, why the firm gave up commissions at the direction of some funds and retained nearly all commissions earned from others. They explained that the amount and type of commissions received varied according to the services provided. For example, commissions may be received because of sales of fund shares or because of research. Separate internal records are not kept for commissions from these two sources (1236), except for a small amount of business received as payment for a special technical research program, described in the record (1236-39). The witness also pointed out that MJT may receive commissions because of its ability to reciprocate on regional exchanges (1234-1236). Direct executions have been increasing relative to give-ups as a source of commission income. This was attributed to the development of the firm's block positioning department and its increasing ability to handle institutional trades (1240-1242). They prefer to execute orders rather than receiving give-ups, citing the prestige involved, among other factors (1241).

Most institutional trades are executed on the NYSE. However, where a block execution is involved, a somewhat higher proportion of trades are done on the regionals and in the case of crosses, where the broker has both sides, the percentage done on regionals is even higher (1247).

Mr. Jones described in some detail the processed involved in executing a block trade and the various techniques that might be used to dispose of a single large block, including a cross of part of the order, a purchase by the specialist of another part, and working off the balance on the floor of the NYSE. He gave an example of a recent transaction, which he said was typical of a large trade (1230-

1234). In this particular trade, one of the MJT specialists present had bought part of the stock and he described his role in the transaction.

Give-up Practices

A summary of commissions received and paid out on various exchanges was submitted as Exhibit 97 and give-up practices allowed under the rules of these exchanges were described. The give-up on NYSE trades is by check Mitchum Jones has occasionally given up as much as 90% of the commission earned on a trade to other NYSE members (1245). On the MSE the firm may give up as much as 60%, but the average arrangement is for a 50% giveup. From the 40 or 50% which it retains, MJT must pay floor brokerage and clearing charges. The firm has no arrangements for paying reciprocals on the MSE (1245-1246). Substantial business is done on the BSE, all consisting of crosses taken there at the request of clients. The rules of BSE regarding give-ups were summarized, particularly those dealing with give-ups to NASD members on unrelated trades. These rules allow give-ups of 50%, 40% may go to NASD members, the other 10% can be paid only to BSE members (1264-1265). An arrangement with Cantella, which had been described earlier in Cantella 's testimony, was discussed. Mitchum, Jones wrote Cantella a check representing 10% of commissions on its BSE trades over a period of time. This represented give-ups which could be paid under BSE rules to Boston members but could not be paid to NASD members. In return for this Cantella would direct 40% give-ups he had available on his trades to NASD members named by MJT. Cantella received $1.50 for every $1 he paid out under this arrangement (1247-1250). MJT received give-ups to NASD members, which it needed, in return for give-ups to BSE members, which it did not need.

PCSE rules distinguish between give-ups by check at the direction of institutions and at the direction of public customers, with institutions getting more favorable terms in order to encourage institutional trades (1251). In both instances give-ups can be paid only on related trades (1296). Institutions may give-up 70% a maximum of 257, to a "preferred rate" member and the remainder to a PCSE member. Individuals may request give-ups of 50% but these can go only to PCSE members, not to "preferred list" members (1251-1253).

Give-ups may be paid to other PCSE members on unrelated trades through use of the 4-way ticket, naming another member to execute and clear the trade (1253). The historical development of the 4-way ticket was described briefly (1296-1297, 1298). An example of a 4-way ticket was introduced as Exhibit 99 and the witness was asked to describe the various symbols appearing on the ticket (1253-1256). The ticket involved a specialist trade where MJT's customer was on one side and one of the firm's specialists on the other. Another firm was named to execute and clear each half of the trade and a give-up of 50% was paid on each side (1280). However, as there is no commission on a specialist trade, MJT was in effect paying out 100% of the commission it earned on that trade (1255-1256). The 50% paid out against the specialist's trade is not charged on MJT's records against the specialist activities, but is charged against the firm's general commission business (1307).

Using IDS as an example, it was brought out that although IDS is named on a 4-way ticket as MJT's agent for executing the trade, IDS has no man on the floor and, in fact, MJT does the execution and charges IDS floor brokerage for doing so (1259-1260). There was also a discussion regarding the liability of the firm named to clear the trade on the 4-way ticket (1260-1263). It was stated that in this situation the liability was joint (1263). Other than that, IDS has very little responsibility in either the execution or the clearing of the trade (1285).

The staff introduced, as Exhibits 100 and 101, ledger accounts for Wellington Co. and Crosby Corp. describing, by exchange, the commission activity for those two groups. The witnesses were questioned in particular regarding figures showing that on some exchanges they were paying out nearly all or even more than the total of the commissions earned on that exchange from executions for the particular fund involved. The exchanges with which this occurred were the BSE and the PCSE, where exchange rules enable a member to give up on unrelated trades (1264-1366).

Somewhat the same idea had been brought out earlier in a discussion involving the question of whether the 70% limit on give-ups by check on the PCSE provided an effective limit on give-ups on a particular trade when the 4-way ticket could be used to give-up additional amounts. The witnesses stated that while the PCSE would not allow both a 70% give-up and a 4-way ticket give-up on the same trade, the same effect could be obtained by using unrelated trades to give-up the extra amount (1257-1258, 1279-1280, 1267).

The witnesses indicated that they look at the overall business derived from a fund complex and not the exchange on which an order is executed as the basis for give-ups (1266-1267). They were quite frank in stating that give-ups on unrelated business on regional exchanges were being used to pay obligations incurred on NYSE trades, but that this was always done within the rules of the exchange involved (1264-1267, 1296).

Mitchum, Jones apparently actively seeks reciprocal business. It is the largest user of 4-way tickets on the PCSE (1305). A major reason for the acquisition of additional specialist posts on that Exchange in recent years has been to generate additional reciprocals with which to repay obligations on other exchanges (1268). The witness also agreed that firms with reciprocal obligations on the PCSE tend to do more business there because of it. However, MJT has always been very active on the PCSE (1270). Odd lots in dually listed stocks are sent to the PCSE, as they have been for many years, both because of convenience of operation and because of reciprocity (1242,1271-1272). Medium-sized round lots are tried first on PCSE and MSB before being sent to New York. About 60% of the orders of under 500 shares are done on the PCSE, a figure higher than for other member firms (1243, 1269-1270). He indicated that there may be some slight cost savings involved in executing on the Pacific Coast, that the firm's wire system is set up for executions there, and that the firm does have a basic loyalty to that Exchange because of its California basis of operation (1242, 1270). He also pointed out that odd lots and small round lots are loss leaders and that, if they can be used as the bases for reciprocals, the firm may be able to earn 1-1/2 commissions instead of a single commission (1242-1243, 1271-1272).

IDS and United Funds

The firm's operations with the IDS-IDSS group (1275-1290) and with the Waddell& Reed/United Funds/Kansas City Securities group (1290-1296) were described in some detail.

IDS Securities was identified and its relationship to IDS was explained (1278-79). Exhibit 102 was admitted, summarizing the firm's ledger account for IDS. This account reflects the various arrangements between IDS and MJT. The major arrangement involves a transaction whereby IDS will direct give-ups on NYSE trades to MJT. Checks are received about once a month from Scheffmeyer & Co., now Lief, Werle & Alston, reflecting these payments. In return MJT will name IDS to receive 50% of the commission on PCSE trades through the 4-way ticket device (1275-1285). Mitchum Jones had received $800,000 under this program ($800,000). It retains 1/3 of this amount for acting as conduit and returns 2/3 to IDS (1278). The 2/3-1/3 ratio is computed on the basis of net payments to IDS after floor brokerage and clearance (1280-1282). While the 4-way ticket allows a give-up of 50%, IDS net only about 38% after paying charges for floor brokerage and clearance (1281).

The witness indicated that MJT has a similar arrangement with Waddell & Reed whose brokerage subsidiary, Kansas City Securities (1292) also receives give-ups via the PCSE 4-way ticket (1290-1296). However, in this case, rather than receiving give-ups, MJT acts as a lead broker for United Funds on the NYSE, Amex and PCSE (1290). Where the trade was executed on the PCSE, Mitchum Jones often does it for floor brokerage along (1290-1291). On other exchanges, it will receive the full commission but reciprocates through the 4-way ticket in a 1-3/4:1 ratio. In this situation MJT retains 43% and pays out 57% (1292). This means that the firm receives only 10%, of the commission more than it did in the case of IDS (retains 43%, vs. 33% retention with IDS), and in return for this 10% it must execute and clear the fund's trade. However, it prefers the KCS arrangement, because it likes to do the executions (1294). He indicated that the IDSS method is perhaps more profitable for MJT, but not necessarily so when all factors are considered (1298- 1304).

From September 1967 to June 1968, MJT received $762,000 from Waddell & Reed under this arrangement. Commission Exhibit 103 included various statistical data relevant to the United Fund account (1295).

Other Give-Up Arrangements

The firm does not share fees on tender solicitations and it does not give-up on OTC trades (1303). However, it does give up at the direction of banks, using the same methods used with funds (1303). A bank may under PCSE rules receive the preferential discount if it has met the requirements to become a preferred rate member (1304). Apparently banks have not made much use of this technique. He described one bank where the bond department, which deals directly with the public, used the preferred rate but the trust department, so far as he knew, did not. The witness did not know what the bank did with the commission savings but indicated that he felt maybe they kept it (1303-1305).

Policy

Certain policy questions were discussed at various points during the testimony. Aspects of the specialist responsibility under the rules of the PCSE were discussed briefly. The witness indicated that this had been a controversial area in recent months among Exchange members (1282-1274).

It was pointed out that IDS returns commissions earned by IDS to the fund shareholder. In response to a question from Mr. Rotberg, Mr. Jones stated that it was of no concern to MJT that the money went back to the investor (1285-1286). He felt that philosophically there was good reason for the dollars to be going back and that this practice was a natural evolution from the practice on the NYSE whereby a NYSE member could reduce fees on investment advisory accounts in accordance with the commission volume in that account (1286-1288). He stated that he favored the Waddell & Reed arrangement where 50% of earnings are returned to the shareholder, rather than the 100% returned by IDS, feeling that the securities firm should be allowed some profit for its effort (1285-1287).

The question was raised as to whether there would be any objection if NASD preferred list members returned commission dollars to funds through lower advisory fees on funds which they managed. Mr. Jones indicated that he would not object to this. However, another witness, Mr. Rickershauser, who is also counsel for the Exchange, stated that there was some question as to whether this is permitted under PCSE rules and that the Exchange staff is presently studying the question (1299-1289).

Mr. Jones felt that institutional membership on the PCSE had been beneficial to the Exchange. Activity has been increased because of it and more NYSE members induced to join (1287).

Mr. Rotberg asked Mr. Jones whether he would favor allowing reciprocals to NASD members through the 4-way ticket on the PCSE. Mr. Jones indicated that the non-member preference rate had been of little value to the PCSE because only infrequently could a trade be directed for execution on the PCSE, and giveups to preferred list members were permitted only on related trades. He felt present give-up policy probably put the PCSE at a disadvantage relative to certain other markets. He would favor allowing use of unrelated business as a means of getting reciprocals out to NASD members. However, apparently he and the various other witnesses present felt that the 4-way ticket was not the proper vehicle to meet this objective (1298-1302).

Mr. Jones stated that the above matters reflected his own opinions or philosophy and did not represent the views of the Exchange nor perhaps even of his firm. Mr. Richershauser stated that they had understood that the hearing was to be an investigation limited to factual matters and since policy questions had been asked the firm would like to reserve the right to submit policy positions on various questions raised throughout the hearings (1309).

Mr. Rotberg noted that certain of the witnesses held or had held official positions with the PCSE and that there were others who had had long experience on the floor of the Exchange. We thanked the representatives of the firm for coming and giving us the benefit of their experience during these hearings (1306-1309).

<u>Exhibits</u>

Exhibit 97 indicates by Fund the commissions earned from 12 fund complexes, the exchanges on which they were earned, giveups received and the exchanges from which they were received, and the giveups paid out by exchange at the direction of the fund managers. It also includes the dealer concessions earned from each fund complex. Exhibit 100 is a ledger account showing the same type of information on a monthly basis for the period from January 1966 through May 1968 for Wellington Co., while Exhibit 101 is a similar ledger for Crosby Corp. Exhibit 102 includes the same data for IDS and Exhibit 103 for United Funds. Exhibits 102 and 103 also include, in addition, a weekly summary of the account status of IDS and United Funds, showing commissions earned, amounts payable, payments made and weekly totals of allocations of commissions on the 4-way ticket to these two fund complexes.

Exhibit 98 was reserved for an exhibit showing payments received under the MJT "technical research" program from all funds named in Exhibit 97 other than IDS and United Funds. Exhibit 99 is s sample 4-way ticket on the PCSE.

STIFEL NICOLAUS & CO., INC.
Testimony July 16. 1968 -- p.p. 1310-1362

Introduction

Stifel Nicolaus & Co., Inc. (SN) is a member of the New York, American and Midwest Stock Exchanges. It is a "regional" firm based in St. Louis, with ten other offices throughout the Midwest (1313). It has a floor broker on only the Midwest Stock Exchange (1312).

This firm was called primarily to explain procedures it developed to channel give-ups to brokers who are not exchange members. The principal witness was John W. Bunn, executive Vice-President and managing officer of Stifel Nicolaus.

SN's capital was approximately $3% million in 1967. In that year, the firm's net profit before taxes and before bonuses to voting shareholders was $561,000; after taxes and bonuses and before distribution to partners it was $277,000 (1358).

In 1966 the firm received gross commissions for executions exclusive of give-ups of $640,030 (26% of total listed commissions) on the NYSE, $125,123 (5% of total listed commissions) on the American Stock Exchange and $285,360 (12% of total listed commissions) on the Midwest Stock Exchange. In 1967 those amounts were, respectively, $931,021 (27%), $244,473 (7%), and $590,807 (18%), (1314, 1315, and Ex. 104). SN's commissions for over-the-counter agency transactions amounted to $167,249 in 1966, and $324,692 in 1967 (1315 and Ex. 104). It is the policy of SN to charge regular NYSE commissions on this business (1358).

In 1966 and until May, 1967 the firm made markets for 40 to 55 over-the-counter securities (1317). In May, 1967, the firm reduced its activity in the over-the-counter market and it presently acts as market maker for only seven such securities. Mr. Bunn stated that these seven primarily have a midwest rather than national market (1316).

The firm transacts business for institutional customers on a direct basis. Institutional execution business accounts for between 20 and 25% of the firm's gross commission income (1317). (In this context, "institution" was defined to include a mutual fund, a bank, an insurance company and "a large organization" (1317).) The remaining 75% of the firm's commission business is attributable to general retail business for customers.

The firm sells mutual funds. Its gross income for all mutual fund sales in 1966 was $369,809; in 1967, $251,845 (1318). Mr. Lewis, SN Treasurer, verified that mutual fund managers direct give-ups or commission dollars for other transactions to SN as an incentive for SN's selling fund shares or as a reward for past merchandising efforts. In 1966, give-ups received by SN amounted to $79,531; in 1967, $58,495 (1318). Mr. Lewis stated that the lesser amount received in 1967 was due to a drop in both gross income and dollar volume of mutual fund sales for that year (1319). He said that give-up income represented about 2% of SN's gross sales income (1321).

<u>Give-Up Arrangements</u>

Apart from the give-ups received as additional compensation for the sale of mutual fund shares, Stifel Nicolaus also receives a substantial amount of give-ups at the direction of fund managers for distribution to other broker-dealers. In 1966 the firm received $1,345,664; in 1967, $1,569,373 (1321). In 1967, 46% of SN's gross income was derived from handling these distributions (1358).

When asked to explain why fund managers directed such amounts to his firm, Mr. Lewis answered that the money was for redistribution to NASD members that the fund managers wished to compensate for their sales of the fund shares (1321-1322). The mutual funds send, by check, give-ups to SN. SN, in turn, sends 60% of the amount it receives to NASD members specified by the fund (1322). These distributions are reported on SN's annual Income and Expense report to the NYSE (1349).

The process by which Stifel directs give-ups, divided into a three-step process, was explained in detail. The initial stage involves the execution of portfolio transactions by mutual funds on the NYSE. The mutual fund manager might choose, for example, four lead primary brokers, primarily on the basis of their ability to obtain executions or to provide other services to the fund or its manager (1323). The mutual fund manager and the primary brokers at some point arrive at an agreement that a certain percentage of the minimum commission will be given to SN; the percentage ranges from 50% to 70% (1324).

At the second stage, the fund advises SN by letter that a lead broker is sending SN a give-up (1326). i.e., the agreed upon 70% of the total primary broker's commission. A covering letter from the primary broker arrives at SN with the primary broker's check.

At the same point, SN receives another letter from the fund manager directing SN to direct a portion of the money to designated NASD only members indicating the amount each is to receive (1326). This letter specifies that the NASD members therein named are to receive 60% of the amount sent SN by the primary brokers (1326-A). [Mr. Bunn stated that this 60% figure was originally 50%, but that SN increased it later to 60% for competitive reasons (1343). It appears to have been 60% at least throughout 1967. (1343)] The fund manager also directs a letter to the designated NASD member recipients advising them that the fund has instructed SN to send the NASD member a give-up check from "the net brokerage commissions," presumably, of SN (1326-A). Mr. Bunn stated that the money received from the lead broker is credited to a separate account in the SN books entitled "Mutual Funds, Special." (1328)

At this point, it becomes necessary to look back to SN's planning for the arrangement being described. SN records the over-the-counter transactions that it has executed over some previous period of time.

This record is of over-the-counter trades SN has made with other NASD members, and includes, in addition to agency orders executed for customers

(1) transactions from SN's own trading account.

(2) inter-dealer transactions where SN is buying as principal from another NASD dealer, and

(3) transactions as market-maker in over-the-counter securities (1328, 1329).

Then a list of these transactions is compiled by SN to send to the NASD member designated to receive the give-up by the mutual fund (1330).

The list SN sends to the NASD member includes the person from whom SN bought or sold to, the date of the transaction, the security involved and its price, and a computation of one-half the NYSE commission (1330 and Exhibit 108). The letter from SN states "We have today credited your account with one half the New york [sic] Commission on the following trades:" and lists the trades (Ex. 108).

The transactions involved include some where SN was acting as principal so that there may or may not have been a charge equivalent to the NYSE commission (1330). The one-half of the NYSE commission on the transactions sent is apparently calculated so that it comes out equal to the amount SN has been requested by the fund manager to give up to the NASD member (1331). Note that these NASD members were in no way involved in the transactions on the list and did not even know that the transactions had occurred before they received the list (1332). They have performed no function whatsoever in connection with either the execution or clearing of these transactions (1332). Mr. Bunn stated that he did not know how the NASD member recipients of the give up recorded the transactions in their books and records but that he thought that they recorded it as income (1331).

Mr. Bunn was asked why he sent a list of SN's over-the-counter transactions to the give-up recipient and requested him to return it to SN under his own letterhead (1332). His only answer was that SN thought it best to actually send the recipient a list of bona fide SN trades for reproduction so that there would be a "clear record of what these moneys were expended on." (1333) He then stated that the dollars sent to the recipients were not from any SN over-the-counter commissions; if SN had received no commission dollars from the NYSE transactions at the direction of the fund manager, SN would not have sent any money to the designated NASD member recipients (1333). Apparently, this amounts to giving up an over-the-counter account rather than the commission from an over-the-counter transaction (1333). No problem of compliance with NASD rules is involved (1334); a discussion to that end was held with Mr. Bunn of SN and between Mr. Bolton of the NASD (1338).

Assuming that a NYSE commission approximated one percent of the dollar volume of over-the-counter transactions, and that half of that one percent would be the amount necessary for SN to compute to cover its give-ups to designated NASD members, SN would need over-the-counter transactions totaling $3,360,000 to cover the $16,800 it distributes in the example (1335).

Mr. Bunn was asked why send a list of SN's over-the-counter transactions to the recipients. Why did not SN merely compute what half of the NYSE commission would be on SN's over-the-counter transactions and send the NASD member a check for that amount (1335). He answered that the former method was preferred because it gave SN a good record of exactly what trades were being "paid out" (1335). He indicated that the list never enters the books of SN, that Mr. Meyer keeps separate records of these arrangements for himself (1335).

Mr. Bunn testified that to the best of his knowledge, this arrangement of give-ups was invented by SN (1336).

Mr. Bunn stated that he had discussed the give-up arrangement with the NYSE and that the NYSE had found it unobjectionable (1336). He stated that the NYSE requested that the give-up be computed at one-half the NYSE commission (1337) and that he could not answer as to whether the NYSE would have objected if SN had decided to give up more than half the NYSE commission (1337).

In December of 1964, SN had received for distribution a total amount of $51,000 from mutual funds. Its own over-the-counter volume was insufficient to handle this amount. SN notified its funds of the situation, volunteering to return the money to the funds. The funds at that time directed SN to send the money to certain other NYSE member firms. No fund or fund manager asked that the dollars be returned to them (1340).

Mr. Bunn testified that no management company had ever requested SN to distribute commission dollars back to the management company as an NASD member or to an affiliate broker-dealer, and that, never having been requested to do it, he had given no thought to what he might do if he was so requested (1348).

In order to remedy this situation, SN asked and received from the NYSE permission to form a "syndicate" of other NYSE members which would enable SN to use their over-the-counter volume for distributing the give-ups (1341). (No subsequent discussions have been held with the NYSE (1348).) The other firms listed their over-the-counter trades similarly to the way SN previously had and sent them to SN (1341). SN used these lists in the same manner as they did their own (1342).

Of the retained 40% of the commissions transmitted to them from the fund through the primary brokers (60% was paid out to NASD members) SN retained 10% and split the remaining 30% among the other syndicate members (1342). So SN retained 25%, the syndicate members retained 15%, and the NASD members received 60% of the total commission dollars which SN received from the primary brokers (1343).

In 1967, SN received $1,569,000 from primary brokers at the direction of fund managers (1343). Of that amount, SN distributed 60% to NASD recipients (1343). The estimated total dollar volume of over-the-counter transactions necessary to cover the distribution of this amount would be $180,000,000 (1345). [60% of the money received by SN was distributed. 60% of about 1.5 million -- $900,000 which represents % of the NYSE commission of 1%. The full NYSE commission would be $1,800,000. $1,800,000 is 1% of $180,000,000] (1344, 1345).

In describing the growth of this arrangement, Mr. Lewis testified that in 1963, SN grossed $60,000 retaining $16,000. By 1967, SN grossed $1,569,000, retaining $419,000 (1345).

Mr. Bunn testified as to the beginning of the arrangement. A St. Louis NASD member, a principal in the firm, asked Mr. Bunn over lunch if there was any way of getting reciprocal business back to him on exchange business (NYSE?) that he would give SN. Mr. Bunn told him no, there was no way because he was not a member of any exchange (1346).

Later, after SN had formulated the plan and taken it to the NASD and NYSE, they contacted the St. Louis NASD member and explained the plan to him. He in turn informed the fund. The fund immediately called SN and SN explained the plan (1347).

A list of the 15 fund management companies participating in the SN arrangement in 1967 appears on page 1347 of the official transcript.

Mr. Bunn admitted that this arrangement was also being used in connection with American Stock Exchange business (1361, 1362 and Exhibit 109).

Mr. Bunn was asked whether he thought it would be desirable for the NYSE to amend its rules in order to permit give-ups directly to NASD members without the arrangements SN had devised. He answered that while it would be undesirable from SN's point of view, he could not see why it would be undesirable from the point of view of the general financial community (1360, 1361).

SN submitted a formal statement in which it pointed out that 30.2% of its accounts were unprofitable in that commissions received did not cover clearing costs (1351). They stated that, in addition to these losses, the firm provides many peripheral services to their customers without cost (1351-1352). SN stated its position that given the great increase in overhead costs the minimum commission schedule should be revised upward rather than downward (1352); that give-ups are an important part of income and should be continued (1353). SN is opposed to the volume discount on the grounds that insofar as the large order subsidizes the little investor, the large order benefits from the stability and depth of the market provided by numerous small investors (1354).

<u>Exhibits</u>

Five exhibits were introduced during the hearing. Exhibit 104 was a statement of SN's commission income and gross income from mutual fund sales for 1966 and 1967 and through March 29, 1968. Exhibits 105, 106, and 107 were introduced by the Commission as step-by-step examples of the give-up procedure that SN employs, tracing the give-up and percentages transferred from the fund through the lead brokers to SN and finally to the NASD member recipients. Exhibit 108 was a set of examples of the form letters and documents which flow among the fund, the primary brokers, SN, and the NASD member recipients. It includes five specimens, the purposes of which are explained on the first page of the exhibit. SN drafted these and employs them in its give-up arrangement.

H. O. PEET
July 17, 1968 -- Pages 1363-1458

Introduction

H. O. Peet has its main office in Kansas City, Missouri with three branch offices in that city and one in Omaha (1366). The firm has 46 registered representatives and 10 general partners. Peter Barnes, a general partner, testified for the firm. Peet is a member of the NYSE, Amex and Midwest but does not have its own floor broker on any of these exchanges. Research is done basically for the public (1367). The firm's income from cash sales of mutual funds was $313,195.70 in 1966 and $373,490.16 in 1967 (1367-1368). Its total commission income in 1967 was $2.2 million (1368). In 1967 the firm's commission business (executions) on the NYSE was $920,546.93; on Amex $184,065.82; on the Midwest $510,137.36; and on Detroit $10,477.36. Its over-the-counter business was $214,976.18 and income from principal transactions was $66,081.32, most of this representing profits on market making activity in seven local securities (1369).

In 1967 the firm's commissions from executions for mutual funds amounted to $109,405.90, which represented orders for seven funds or fund complexes. There were give-ups on these executions only in certain small instances (1371). The firm received give-ups at the direction of mutual funds on the NYSE in the amount of $313,195.70 in 1966 and $373,490.16 in 1967 (1372). [Footnote: The firm's 1966 I&E report was incorrect, showing $125,000 less than the actual figure. This represented $125,000 in give-ups received in connection with the over-the-counter give-up program described later. In 1966 this figure was erroneously reported as an OTC give-up rather than an NYSE give-up (1371-1372).] In general, the funds for which Peet sells the most shares are the funds from whom Peet receives the most give-ups (1373).

Give-up Arrangements

In 1967 Peet's sales for Keystone were $2,382,574.00 and Peet received give-up checks for $272,500. Sales for Hugh W. Long were $2,168,147.00 while give-up checks received were $44,150. The variance in the amount of give-ups received is due to the fact that Peet has "an arrangement with Keystone Funds of Boston, whereby we share commissions on our own over-the-counter business and are compensated by the use of -- by the receipt of New York Stock Exchange checks." (1374)

Originally a member of the Stifel syndicate, Peet began its own independent operation in late 1965 (1375). Keystone is the only fund with which Peet presently has this arrangement (1374) and Keystone is willing to absorb all of Peet's over-the-counter give-up business (1377). In 1967 the firm also shared commissions of $2,704.96 with NASD members at the direction of Security Management Company (1374). The witness believes that Keystone also uses Boettcher & Co. and Rauscher Pierce & Co. Newhard Cook & Co., as well as Stifel Nicolaus, also use this technique according to the witness' understanding, although they do not have this arrangement with Keystone (1376).

Peet adopted the Stifel plan without change. Pursuant to the instructions of John Bunn (Stifel Nicolaus & Go). Peet would assign to all over-the-counter trades, both principal and agency, an amount equal to one-half of the NYSE commission (1378). If Peet had $50,000 in gross over-the-counter commissions in a month, it would be able to give up $25,000. Keystone would send them a check for $41,666.67; Peet would give-up $25,000 and keep the remainder (40%) as profit (1377).

The firm shares commissions on a 50% basis -- it is willing to give-up 50% of the imputed over-the-counter commission. The 50% figure is used solely because that is the ratio used by Bunn. Peet had no indication that the NYSE had approved the figure; the witness did not know why Bunn had chosen the 50% figure (1379).

Once a month Peet notifies by telephone the Keystone Management Co. of the amount of their over-the-counter business (1380); upon notification Keystone directs NYSE give-up checks to Peet (1381). Keystone sends a letter to Peet stating that Keystone has directed a designated NYSE firm or firms to send a give-up check to Peet, courtesy of an NASD dealer (1383). A "credit" letter and a list of the over-the-counter trades is then sent to the NASD dealer (1385). This letter is sent because Bunn advised Peet to do so (1387). The NASD dealer returns a "debit letter" and a copy of the over-the-counter trades, this too being done pursuant to Bunn's advice (1388).

The character of the correspondence was described in some detail in the testimony and samples were introduced as exhibits. The purpose in exchanging the list of transactions and in using the terms "debited your account" and "credited your account" was discussed (1384-1397). No NASD member has refused to sign and return the list and, as far as Mr. Barnes could recall, none has ever questioned the procedure (1396).

Upon receipt of the debit letter, Peet sends the appropriate give-up check to the NASD designee (1393). The firm has never directed an over-the-counter give-up to Keystone or to any other investment advisor or management company (1376, 1396).

The New York Stock Exchange is aware of this committing splitting arrangement having discussed it with Mr. Bunn of Stifel Nicolaus and on two or three occasions with representatives of H. O. Peet. Mr. Barnes could not remember the exact content of the conversations with the Exchange staff but indicated that their "terminology was such that we understood the procedure was not inappropriate." (1402) Notes taken by the witness's father at a meeting with Mr. Bunn, which referred to Mr. Bunn's conversations with the New York Stock Exchange, were introduced into the record (1400). The NASD, which was also aware of the procedure, did not either approve or disapprove it in conversations with Peet, although Peet indicated a willingness to stop if the program violated NASD policy (1403).

Exhibits

109 A (1368) -- 1968 Mutual fund sales -- top ten

110 (1374) -- correction to Exhibit 109A

111 (1381) -- Keystone letter advising of forthcoming give-ups directed to Peet and cover letters from NYSE members transmitting these give-up checks.

112 (1383) -- Keystone letter advising of forthcoming give-ups.

(1394) -- courtesy of designated NASD member.

113 (1385) -- "credit" letters from Peet to NASD members and transaction list

114 (1393) -- "debit" letters from NASD member to Peet and transaction list

115 (1393) -- correspondence between J. A. Schreiber & Co. and H. O. Peet

116-117 (1395) -- complete series of correspondence involving a Keystone give-up transaction.

118 (1397) -- ledger sheets of H. O. Peet showing the flow of give-ups from Keystone, through Peet, to the NASD designees of Keystone

119 (1400) -- notes of Peter Barnes Sr. reflecting conference with John Bunn. Bunn advised Barnes the NYSE had no objection to Stifel-Peet scheme.

E. F. HUTTON & CO.
Testimony July 17, 1968 -- p.p. 1405-1458

Introduction

E. F. Hutton is a large seller of fund shares but its institutional business, and more particularly its fund business, is relatively small. It was called primarily because of its 4-way ticket arrangements with IDS and Waddell & Reed, whereby it gives up on odd-lot trades on the Pacific Coast Stock Exchange. Mr. Keith S. Wellin, President of E. F. Hutton, was the principal witness.

General

E. F. Hutton is one of the major retail brokerage firms in the country with 3600 employees in 66 branch offices located throughout the U. S. (1405). The firm's 1967 gross income from all sources was $85 million, while gross commission income was $59 million (1407-1408). Hutton is a member of all major exchanges, has men on the floor of the NYSE(7), the Amex (4) and the PCSE (1), and is a member of the clearing corporation of all exchanges of which it is a member (1407). The substantial OTC business is done primarily on a retail basis, with little market-making activity (1408). The firm is a large underwriter and, in addition, derives considerable income from sales of fund shares ($2.4 million) (1408-1409). Hutton has 7 correspondents, 5 of whose accounts are carried 6n an introduced basis. The difference between introduced and omnibus accounts was discussed briefly (1409-1410).

Institutional Business

The firm carries a wide variety of institutional accounts, providing commission income of $9 million. Banks account for 40% of this, non-financial corporations for 12%, and mutual funds for 10% (1411-1412). However, Hutton's orientation is primarily toward its retail rather than its institutional business. There is no institutional department per se, although the firm does have a block trading desk in New York which handles block orders, most of which are from institutions. Other than orders taken by the block traders and five institutional salesmen in New York, all sales and research for institutional customers are handled by regular personnel on a part-time basis (1410-1413). Large institutional accounts are handled as house accounts (1413).

The manner in which a trade is done depends on the instructions of the institution. If the customer gives Hutton a market order, it goes to the floor right away. At other times the firm may be allowed or instructed to look for the other side of a cross, but it does not block position (1414, 1418). Hutton will take an order or a cross to a regional exchange when requested to do so by the customer, but it does not act as principal in a cross in order to allow each customer to select a different exchange (1415). Most trades, however, are done on the floor of the New York Stock Exchange. About 90% of the mutual fund orders are executed on the NYSE and 10% on the regionals. This compares to about 72% of overall exchange commission business executed on New York, 24% on Amex, 3% on the PCSE, and 1% on other regionals (1416-1418).

Mutual Fund Business

As indicated earlier, Hutton is a substantial seller of fund shares. Statistics relating to the ten fund complexes which accounted for the bulk of shares sold by E. F. Hutton were submitted into evidence [Exhibit 120, 121]. Total volume in 1967 for these ten funds was $32.4 million (1418-1419)

From five of these ten groups, Hutton receives brokerage orders for execution (1419). Three groups in particular were discussed. The firm received $280,000 from funds in the Crosby-Fidelity complex and gave up $175,000. It also received give-up checks of $105,000 from that group (1420). From another firm on the list, the Vance Sanders group, Hutton retained all commissions earned and received a small amount of giveups (1421). In the case of the third group discussed, the funds sponsored by Shareholders Management Co., the Hutton received neither direct commissions nor giveup checks (1422).

Mr. Wellin could not explain the difference in policy between the three groups. He did not know why Hutton both received giveup checks and paid giveup checks in substantial amounts in the case of Crosby-Fidelity group (1420-1422). He stated that if Vance Sanders had requested a give-up on its trades, the firm would have given it to them. They received essentially the same service as was given to the Crosby-Fidelity group (1421-1422). He did not know why the largest fund group on the 1967 list, the Shareholders Management complex, was not giving commission business, directly or indirectly to Hutton, but indicated that far more than simple reciprocity is involved in these arrangements. It was brought out in the testimony that the funds in the Shareholders Management Group have been characterized as "go-go" or performance funds. The staff suggested that perhaps Less selling effort was involved with these funds and, therefore, give-ups were not necessary as an incentive to sell fund shares (1422-1426). Mr. Wellin testified that Hutton's mutual fund salesman is not, however, told which fund to sell, but is directed to meet the customer's investment objectives, regardless of whether Hutton receives reciprocal commission business or not (1426).

Giveups

The firm's general policy is to give up 60% at the direction of a fund manager or other institution (1419-1432). The give-up is the same regardless of the size of the order, the fund involved, or any other factor (1431-1432). There were a few funds where the standard give-up was at other than a 60% rate but the witness could not explain the reasons for these differences (1433). Give-ups were sometimes paid at the direction of other institutions, such as banks and insurance companies, but except in the case of hedge funds the amounts involved were small and the transactions infrequent (1452-1454).

The witness indicated that give-ups paid at the direction of hedge funds apparently were going for research, while give-ups paid at the direction of mutual funds went primarily to retail firms as opposed to firms specializing in research or in servicing institutions (1453).

The staff described and put into the record examples of correspondence and records pertaining to Hutton's give-up arrangements with mutual funds. A series of letters containing give-up instructions from the fund to E. F. Hutton were introduced as Exhibit 122 (1426-1427). Copies of ledger accounts showing the credit of 60% of the non-member commission at the time the trade was executed and a debit as checks were paid out at the direction of the fund were introduced as Exhibit 123 (1427-1430). The witness described the record keeping system which enabled an employee to determine at a later time whether give-ups were going only to broker-dealers eligible under the minimum commission rules of the exchange on which the original trade was executed (1427-1430).

A check of Hutton's records showed that there had been no give-ups on Amex transactions, at least in the last two years (1434). Hutton stated it would be willing to give up on these trades, but apparently had not been asked to do so. The firm has a house policy that on regional exchanges it gives up only on related orders and consequently, it does not utilize the Boston Stock Exchange program to give up on unrelated orders (1433-1434). However, it does have arrangements with Waddell & Reed/United Funds and with IDS to give-up via the PCSE 4-way ticket on unrelated orders on return for New York Stock Exchange commissions (1435). This arrangement is carried on almost exclusively with these two groups on the PCSE; there is little or no 4-way business with other PCSE sole members (1444) and there is no similar program on the MSE or other regional exchanges (1442).

Give-ups to IDSS and Kansas City Securities

The testimony went into some detail on the arrangements with IDSS, a wholly-owned subsidiary of IDS, and Kansas City Securities, a wholly-owned subsidiary of Waddell and Reed, manager of United Funds (1437-1446). Both IDSS and

KCS are members of the PCSE, which enables them to earn commissions on unrelated orders by being named as executing and clearing firm on trades executed on the PCSE for Hutton's customers. The witness had only a vague impression as to what happened to the money earned by IDSS and KCS. He understood it was returned to the fund managers but was unclear as to whether the fund shareholder benefitted therefrom and if so, how (1445,1458).

In the case of IDS, Hutton would name IDSS on 4-way tickets on trades with Hutton's customers done on the PCSE, giving up part of the commission earned to IDSS. In return IDS would reciprocate on a 1 1/2:1 basis by directing give-ups on NYSE transactions to Hutton. For example, if Hutton paid commissions on the 4-way ticket of $1,000 to IDSS, IDS would direct Scheffmeyer & Co. (now Lief, Werle & Alston). IDS's major give-up conduit, to send Hutton a NYSE give-up check for $1500 (1435-1436, 1440-1441). In 1966 Hutton received $202,000 from Scheffmeyer and paid out through the 4-way ticket $88,000 while in 1967 the figures were $275,000 and $213,000, respectively (1443). The witness pointed out that the ratio involved had been changed from 2:1 to 3:2 in mid-1966. (1443)

The arrangement is somewhat different with Waddell & Reed/KCS. Hutton acts as an executing broker for United Funds so it receives direct commission business, rather than give-ups, in return for amounts it gives up through the 4-way ticket (1447). The ratio here is 2:1 -- for every $1,000 it pays to KCS, Hutton will receive $2,000 in direct commissions (1447). The total amounts involved are somewhat larger than with IDS. Hutton in 1966 paid to KCS $301,000 and received $606,000 in return. In 1967 the volume paid out was $177,000 while the gross received was $375,000 (1447).

There was a brief discussion concerning Waddell & Reed's arrangement with Jablonski and the possibility that some orders KCS has been forwarding to Hutton for execution may actually represent orders for Jablonski's customers. Mr. Lynch stated that he was not familiar with this situation and had always assumed the trades represented executions for United Funds (1447-1450).

<u>Execution of Odd-Lots</u>

The bulk of Hutton's business on the PCSE is odd-lot trades and the four-way ticket is used for all odd-lots done on that exchange. It is therefore odd-lots done for small individual customers that account for the bulk of the give-ups paid to IDSS and KCS on the PCSE (1438) The witness testified that he believed if Hutton was able to generate more business on the PCSE it would be able to do more business with IDS and Waddell & Reed; that is, that those firms seem willing to absorb whatever Hutton can offer (1439-1452). As indicated earlier, the volume of business on the PCSE is a rather minor part of the firm's total commission business in 1967 totalling about $1.3 million (1416).

All odd-lots from the firm's 22 offices in California (1406) and from its other offices in the Southwest are automatically sent to the PCSE for execution, as they have been for many years. The way in which PCSE odd-lot executions are tied to the New York tape was discussed briefly (1438-1439). While there is a small amount of odd-lot business on the MSE and the DSE, trades from the firm's offices other than those in California and the Southwest are done primarily in New York. There is apparently no thought being given to switching this business to the PCSE in order to increase the give-up volume available on that exchange. Despite the fact that, as far as the customer is concerned, he theoretically obtains the New York price on PCSE odd-lot executions and thus execution of all odd lots on that exchange would be feasible. Hutton appears to be opposed to changing existing practices merely to generate give-ups (1441-1442). The witness stressed that West Coast odd-lot trades were already being done on the PCSE at the time when the arrangements with IDSS and KCS were developed (1442).

In response to a question from the hearing officer, the witness indicated that there was no particular difficulty involved in using the 4-way ticket on odd-lots -- that basically the procedure is a very simple one. While it may require a large amount of trades to accumulate much commission volume, the Pacific Clearing Corporation does the actual clearing and processing and keeps records of the amounts involved. The fund affiliate simply receives a check periodically (1439-1440).

Exhibits

Exhibits 120 and 121 are summaries for 1967 and 1966, respectively, of the dollar volume of fund shares sold and of commission income from direct executions and from give-ups for the ten funds for which Hutton sells the largest amount of fund shares. Exhibit 122 is a series of four letters from mutual fund managers directing Hutton to give up specified amounts to designated broker/dealers. Exhibit 123 is a copy of Hutton's general ledger account for Affiliated Fund, showing debits and credits relating to give-ups for the period January 1, 1966 to December 31, 1967.

DISHY EASTON SUMMARY
July 18, 1968 -- Pages 1509-1595

Dishy Easton (Dishy) is a sole member of the Amex (1514). with four seats on that exchange. Bernard Dishy, a partner, testified, The largest facet of Dishy's business is executing orders on the floor of the American Stock Exchange for others. Floor brokerage now accounts for about 5070 of the firm's gross income; in the firm's earlier years it accounted for approximately 90% of the gross income (1515). Another 40% of the income comes from its full commission business (1516). Four to five percent of its income is attributable to money brokerage business. The firm also does arbitrage; its research is in this area exclusively. The firm does its own clearing (1516-1517).

It has been the firm's experience that if it gave business to a member of the NYSE, that member was more likely to give Dishy Amex floor brokerage. This was so even if the NYSE member was also an Amex member and even if it had a man on the Amex floor, although their business came to Dishy usually only when the NYSE member's Amex floor man was busy (1518-1519). The record contains a list of the NYSE brokers who direct Amex business to Dishy (pp. 1520, 1521, and Exhibit 131). Commission Exhibit 132 shows the dollar amount given to Dishy by 10 NYSE firms (1521-1523). Hertz Warner was the leader in 1967 with $734,000. Give-ups by check are not included in this figure (1522-1523).

Dishy used two principal methods to circumvent the NYSE minimum commission rules and at the same time make money for itself. First, Dishy would direct customers to execute their NYSE orders through designated NYSE member firms. Those firms would give up to Dishy on the Amex. Dishy would then pay a portion of the commission to one of its registered representatives who would deduct 2% for his work and pass the remainder on to the original customer (1524-1526). The second method is for a customer to give Dishy an order for a NYSE listed stock. Dishy buys the stock for its own account and pays a full N\SE commission which is in turn charged to the customer. A portion of this commission would be paid to Dishy's registered representative (1527-1528), who channels it out as described above. Dishy will later get a give-up on the Amex from the New York member. This second type of transaction is now a substantial part of Dishy's business (1528).

The same type of business is obtained through fund managers. To get more business, Dishy went to fund underwriters or managers who could request their funds to direct NYSE commission business to Dishy's designees. Dishy told the underwriter or manager that Dishy would share these commissions with the mutual fund sales organization (1528-1529). In this connection, Dishy approached Investors Planning Corporation (IPC), principal underwriter for Fund of America (1529), and told IPC that if it gave NYSE business to Dishy designees, Dishy could reciprocate (1530). Thus, IPC would give, for example, $1,000 in commission business to Hertz Warner, whom it uses exclusively for its executions. Hertz, on unrelated Amex trades, would direct give-ups to Dishy floor brokers in excess of the $1,000 Hertz had received. Prior to the receipt of these give-ups, however, Dishy would be notified by IPC or Hertz, that Hertz had received $1,000 in commission business (1530-1533). Dishy, upon this notification, would also tell its registered representative to pay 50% to, in this case, IPC. Thus, of the original $1,000, the registered representative would receive a check for $520 and would give a personal check for $500 to IPC (1533). Dishy's W-2 forms reflect, however, that the registered representative received only 2% of the total amount (Exhibit 134). Instructions were given to the registered representative in the form of a memorandum showing the amount of the New York Stock Exchange business and to whom it was introduced. The registered representative would send a cover letter along with this check to the designee. This cover letter was prepared at the direction of Bernard Dishy (1536). One representative used for this purpose was Kenneth Easton (1536). See page 1536 for an example of a memorandum to Kenneth Easton, a check signed by Kenneth Easton made out to IPC, and a cover letter to IPC. In this case, the amount of the check was $30,851.50.

IPC sells the shares of other funds in addition to Fund of America. In this connection, IPC is able to direct commission business from the other funds as well (1537). Other funds, however, direct give-ups to Dishy's designee, at the direction of IPC. These give-ups, in other words, go from a New York Stock Exchange lead broker to another New York Stock Exchange member who is Dishy's designee (1538). Other funds which are sold by IPC include Affiliated Fund, Fidelity Manhattan and Broad Street (1540). At one point, the floor brokerage generated by Hertz Warner to Dishy was not sufficient for reciprocal purposes, so in addition Hertz Warner directed give-up checks to Dishy (1541). To effect this, Norman F. Carney, a partner at Hertz, would send a copy of his cover letter to Dishy. Dishy would sign the copy and return it, and would subsequently receive the give-up check (1540-1543). The effect of these transactions is that the commissions paid by Fidelity, for example, to a broker, were directed from Hertz through Dishy back to IPC in whatever give-up proportion IPC was to expect from those particular funds (1543). In addition to using registered representatives to send back money to IPC, in several cases checks were sent directly to IPC from Dishy (1544 and Exhibit # 138).

Dishy Easton had a similar arrangement with Republic Technology Fund; this practice has since ceased. In this case, the arrangements were made with Charles Salik, President of the Republic Technology Fund, or with a Mr. Urlov who directs the brokerage for Republic Technology Fund. Salik is also a shareholder of Salik Bank of Switzerland. The Dishy registered representative would receive a check for 52% of the New York Stock Exchange commission or Republic Technology Fund trades. Mr. Urlov would give directions to Dishy as to who should receive the give-up check. In some cases, the 50% went to Salik &

Co., the underwriter of Republic Technology Fund shares which is owned by Salik, and in other cases, the 5070 went to Salik Bank of Switzerland (1547). As in the case of IPC, Dishy would get back more than a dollar per dollar ratio of commissions directed to the New York Stock Exchange member firm. This reciprocal business would come back by way of either floor brokerage or give-ups (1548). (In other words, the shareholder's brokerage was going not for sales, but into the manager's pocket.)

The same type of arrangement as described above existed with Renyx, Field & Co., Inc. Payments to Renyx, Field & Co. were made through Elaine Berlin, a Dishy registered representative. See Exhibit No. 143 (1553). Renyx, Field is affiliated with Corporate Leaders of America; it is either the distributor or the management company of Corporate Leaders (1554). In addition to directing commission give-ups back to the underwriter or management company of the funds, the above arrangement was also used to pay give-up checks to an NASD dealer who would ask the fund to direct New York Stock Exchange business to Dishy's designees (1555) in order to compensate the NASD dealer.

Dishy also was involved in a deal with Maxwell Ohlman in which the latter directed a check to Dishy through Michael J. Heaney & Co. In return Dishy directed give-ups via a circuitous route to Ohlman (1565 Exhibit 150).

As early as 1965 or 1966 Dishy had arrangements with IPC in which the latter directed the brokerage of various funds to Dishy in return for over-the-counter fees and fees paid in connection with bank deposits and certificates of deposit (1566-1567). Dishy thinks that Hertz Warner had a concurrent over-the-counter commission sharing arrangement with IPC (1569). For example, Dishy placed a certificate of deposit with the National .American Bank of New Orleans and gave Peter Beckeny $500 of the profit. This payment was in reciprocation for business that was introduced on the New York Stock Exchange by Beckeny. See Commission Exhibit No. 158 (1584-1585).

Dishy had another reciprocal arrangement with Equity Funding Corporation of America (1569). Equity Funding is an organization that sells insurance and mutual funds. Part of its program is to obtain loans on mutual fund collateral to pay for its insurance premiums. As its sales have increased, Equity Funding has endeavored to increase its lines of credit. Dishy's major service to Equity Funding is obtaining lines of credit for these loans (1570). In return for this service, Equity Funding directs brokerage to Dishy in the form of both New York Stock Exchange and American Stock Exchange commissions (1570). Marlena Friedman, a registered representative of Dishy who resides in and operates from Monaco (1572) helped establish a line of credit with a Paris bank for Equity Funding. In return for this loan, Equity Funding directed New York Stock Exchange brokerage to Dishy. Dishy apportioned 60% ($14,281.20) of this to Marlena

Friedman as her share and it was subsequently paid to her. These commissions also might have arisen on the American Stock Exchange or might be a combination of New York and Amex commissions (1573).

In 1967, Dishy also had foreign arbitrage accounts. These accounts were with the following banks: Salik Bank in Basel A.G., Bank de Rhone and Bishops Bank and Trust Company. These banks gave amounts of money to Dishy on a discretionary arbitrage account. Salik Bank gave $250,000; Bank de Rhone, $50,000; and Bishops Bank and Trust, $180,000. See Commission Exhibit No. 153 (1575). The amount given by Salik Bank has increased greatly since the original $250,000 contribution (1576). With these sums, Dishy engaged in arbitrage transactions in the United States. Dishy had agreed with Miss Friedman that all arbitrage accounts by foreign banks would be credited to Miss Friedman. Bishops Bank and Trust Company is located in Nassau, Bahamas; Bernard Dishy has an interest in this bank. The shareholders of the bank are listed on pages 1578 and 1579 of the record and in Exhibit No. 155 (1580). Bishops Bank and Trust Company has not participated in any reciprocal arrangements for brokerage. Thus, the arbitrage commissions were not shared in any manner with Bishops Bank and Trust Company (1581). Bishops Bank is an external bank under Bahamian law. It does not deal in Bahamian pounds but only in foreign currencies. It is permitted to do a banking business only outside of the Bahamas (1581). From September 1967 to May 1968, Marlena Friedman received net commissions of $29,390 from arbitrage accounts, with gross commissions of $48,985.56. See Exhibit No. 157. The net paid to Miss Friedman was 60% of the gross.

Dishy also fulfills some of its reciprocal obligations by the give-up of tender solicitation fees. When Dishy tenders stock, it receives commissions as a result of these tenders and then remits payments to reciprocal obligation. These shares are tendered on behalf of customers of Dishy (1582-1583). Securities Overseas Service, International Securities, and the U. S. Bank Deposit Center are foreign firms that shared in give-ups under this arrangement. See Exhibit No. 156. Dishy does not tender the shares on behalf of funds. For example, IPC, because of some reciprocal obligation which the fund manager owed to it, requests the funds to send certain business to the New York Stock Exchange. This results in business coming to Dishy on the Amex, and Dishy pays for that business out of solicitation fees which it received (1585-1586).

Dishy has or did have two representatives located in the Bahamas. One was Edith McCloud, whose husband is the auditor for the Bishops Bank; the other was Lorna Seligman. At the time Dishy was considering setting up a bank in Nassau, the firm discussed with Mr. Seligman and Mr. McCloud that since Nassau seemed to be the central point of money, Dishy might be able to obtain brokerage business. Since Dishy could not pay either Seligman or McCloud directly, the firm had their wives trained and registered so that brokerage business and the resulting commissions could be directed through them. (The reason for having Mrs. Seligman as the registered representative, rather than her husband, who, aside from being a judge, is also a practicing attorney, is the full time occupational requirement of the American Stock Exchange for registered representatives (1589).)

In about eight months (1587), Lorna Seligman received $155,800 in give-up commissions at the direction of Equity Funding Corporation (EFC) (or Equity Securities; Dishy uses the names interchangeably) (1588 and Commission Exhibit No. 155). The commissions directed to Dishy by EFC were for services performed by Seligman for EFC (1589). In this connection, Mr. Seligman had traveled to Brussels, Paris, Amsterdam, and to Switzerland for EFC. He had introduced EFC to insurance companies and banks, and had acted as an advisor to EFC's planning for setting up a European distribution organization. He also traveled to Hong Kong the Far East, and the Union of South Africa for EFC, giving EFC information as to the possibility of selling its funds (1590). Seligman also helped EFC form some corporations in Nassau. At present EFC is setting up an off-shore hedge fund in which he will be a director. Exhibit No. 160 shows the commissions earned by Mrs. Seligman on other business which the Dishy firm did. They are commissions on individual accounts and some accounts of banks (1591). Mrs. McCloud also got business from foreign broker-dealers. It was up to Mr. or Mrs. McCloud to direct the business to Dishy. They were arranging loans for dealers with banks in Nassau for non-American citizens in order to get leverage on U. S. mutual funds. In other words, they were arranging loans by which mutual fund shares could be purchased on margin (1592). In return, the dealers from whom the mutual fund shares were bought would direct business to New York Stock Exchange firms, and Dishy would get reciprocal business (1593). Mrs. McCloud got 60% of the commissions generated; during 1967, she received $96,794. See Exhibit 161.

Exhibits

Exhibit No. 135 is a series of documents referring to transactions effected by Kenneth Easton as registered representative (1538).

Exhibit No. 136 is a series of documents showing the transactions carried out by George Hegal as registered representative. Hegal also directed or mailed checks to IPC.

Exhibit No. 137 contains examples of these checks and of cover letters from Norman F. Carney, a partner of Hertz, to Dishy Easton.

Exhibit No. 139 illustrates the arrangement with Republic Technology Fund. This chart shows that either the manager of the fund or the bank in which the manager of the fund had an interest was getting commissions back (1549).

Exhibit No. 140 is a series of documents, including memoranda of the New York Stock Exchange business introduced by Republic Technology Fund to Dishy's designees, payments of commissions to registered representatives, and the sharing of that commission by the registered representatives with Salik & Co. and the Salik Bank of Switzerland (1550).

Exhibit No. 141 is a series of documents containing copies of checks by Elaine Berlin, a memorandum from Dishy to Elaine Berlin, an employee statement of earnings and deductions, and a copy of letters written by Elaine Berlin to the Salik Bank of Switzerland, Salik & Co. and also to J. D. Delaney & Associates. Dishy assumes that J.D. Delaney & Associates sells the shares of Republic Technology (1552).

Exhibit No. 142 is reserved for a prospectus of Republic Technology Fund. This prospectus has been introduced into the record (1533).

Exhibit No. 144 is a list of NASD dealers who received checks, letters, and memoranda from Elaine R. Berlin.

Exhibit No. 145 is a list of dealers with whom Dishy's registered representatives share commissions. On this list, the name Consumer Investor Planning Corporation appears. CIPC is an affiliate of an associated fund trust. Give-ups to CIPC follow the same pattern as described above in reference to Salik and IPC.

Exhibit No. 146 is a photostat of a check from Elaine Berlin to Peter Beckony, a dealer residing in Nassau. Another foreign dealer who received give-up checks is Colonial Securities of Boston and Brussels (1559).

Exhibit No. 147 gives the names of these foreign broker-dealers.

Exhibit No. 148 is a list of payments made to Salik & Co., CIPC and Renyx, Field (1560).

Exhibit No. 149 contains charts for Kenneth Easton, George Hegal and Elaine Berlin. These charts show the New York Stock Exchange member to whom Dishy introduced New York Stock Exchange commission business, the amount of the commissions introduced, the payments made to Dishy by its registered representatives, the 1967 date paid, gross pay, net pay, the amount the representative paid to the NASD member, and the name of that member (.1560).

Thus the chart shows that at one time, Donaldson Lufkin & Jenrette received $5,000, Steiner Rouse received $5,000, Roberts Scott & Company received $15,000, and Tessel, Paturick & Ostrau received $15,000. These amounts represent give-up checks received by these firms (1561). The total amount of New York Stock Exchange commissions introduced by Kenneth Easton was $688,534 (1562). Of this, $339,193 was paid to NASD members or to other broker-dealers who were selling mutual funds. George Hegal introduced $685,504 and paid out $338,773. Elaine R. Berlin introduced $428,170 and paid out $207,792 (1563).

Exhibit No. 149A is reserved. Mr. Dishy is to supply the name of a payee whose name was missing on the Elaine R. Berlin chart (1564).

Exhibit No. 151 is a list of the banks which were approached in order to arrange loans on behalf of Equity Fund (1571).

Exhibit No. 152 is a commission statement of Marlena Friedman.

WEEDEN & COMPANY
July 18, 1968 -- pp. 1462-1508

Weeden was called as a witness to explain the nature of the Third Market, particularly with regard to the negotiated character of that market, the use and impact of give-ups, and the competition provided to the primary market. Donald Weeden, a vice president of the firm, testified.

General

Mr. Weeden explained that the business of his firm consisted of market making in over-the-counter and listed NYSE securities (OTC trades account for only 4% of the total of these two categories), of dealing in the secondary market in municipal and corporate securities, and of underwriting municipal and corporate bonds (1462). The firm does not sell mutual funds (1496). After a brief discussion concerning what was meant by the "secondary market in municipal and corporate bonds" (1462-1464), the rest of the testimony was concerned with Third Market operations.

The witness testified that the term "Third Market" had come out of the Special Study and meant a market in NYSE listed securities being made away from the NYSE by certain non-NYSE members (1463-1464). It is primarily a dealer-risk business, whereby firms risk their capital to finance inventories maintained in their market making activities. Only 10% of Weeden's business is done on a riskless basis (1465).

Weeden has seven offices, by far the largest of which is in New York. A London office of the firm maintains a market in NYSE-listed securities for European customers at hours when the office is closed in New York (1468-1469).

The firm makes a market in 240 listed common stocks of which 90 are utilities, 10 are railroads, and the remaining 140 are industrial issues. The factors determining which securities are selected for this list were described briefly. The major consideration is the extent of institutional interest in the issue. Weeden advertises through the pink sheets and through a brochure it issues periodically, listing the securities in which it is making a market (1470-1477).

In 1967, the firm bought about 35 million shares and sold about the same number. Mr. Weeden estimated that the 1968 figure would be about 45 million shares on each side (1504). Exhibits 125 and 128 give figures on total volume of shares traded, and volume broken down by class of customer for different periods to date in 1968 (1473-1474).

Categories of Customers

The witness stated that Weeden's business was confined almost entirely to professional or institutional investors (1467). The firm does business with about 1,100 banks and insurance companies, with about 64 mutual fund complexes, and with about 2,790 broker-dealers in the U. S. and Europe (1469-1470). A list of the ten largest customers, which includes seven banks and three fund complexes was submitted as Exhibit 129 (1495-1496).

The bulk of the share volume of trading involves transactions of over 3,000 shares, although odd lots account for the largest number of trades. In June 1968, 46.7% of the share volume was on trades of over 3,000 shares but these accounted for only 2% of the transactions. Odd lots make up 62% of the number of transactions but are only 6.2% of the volume of shares traded (Exhibit 126; see also Exhibit 130). Odd lots are executed primarily for banks and non-member broker-dealers, while large orders come primarily from banks and mutual funds. Exhibit 127 summarizes for 1967 the frequency distribution of firm business, classified by type of customer, number of trades and size of trade (1476-1478).

Mr. Weeden stated that the type of competition offered by the Third Market depends on the type of business involved. On odd-lot business and probably on transactions involving up to 500 shares, the Third Market competes primarily by offering a discount commission. On trades of over 3,000 shares, the willingness and ability to position securities becomes the major consideration, while the commission savings of 1/8 to 1/4 point becomes less important (1506-1507).

Operations

The extent of the firm's willingness to inventory securities was discussed briefly. The witness indicated that on a recent date the firm had had a dollar long position of $2,3.5 million ($1.2 million of this was in OTC securities) and a short position of $7.2 million (1474). Inventory turnover averages once a week (1494). He gave, as of another recent date, a breakdown of the large positions held, classified by size. Weeden is willing to consider bidding on blocks of 50,000-100,000 shares and occasionally has bid on larger blocks (1479).

The activity was compared to the volume done by the specialists on the PCSE. Mr. Weeden stated that in 1967 Weeden's average inventory position was about twice that of all specialists on the PCSE combined. The witness gave a figure published by the Exchange as to the volume of specialist trading, but because he did not know whether the PCSE figures included purchases plus sales or only sales, he could make no comparisons with the volume of his firm (1504-1506).

The firm is able to liquidate even sizeable positions because of the volume of business it does with a variety of customers. It also considers in making its inventory decisions the ease with which the position can be sold. Furthermore, Weeden does have adequate capital to retain positions over a period of time, if necessary (1498-1499). The firm does not, as a general practice, sell on the NYSE to close out or reduce positions. As far as Mr. Weeden could recall, the firm has not made a sale on the NYSE in the last 3 years (1467). Weeden may, however, buy on the NYSE at a full commission to reduce inventory exposure where it feels it is advantageous to do so. This represents less than 2% of its business (1487-1488).

Many factors enter into the determination of what price the firm will bid and offer. The price on competing markets is a very important consideration. The firm tries to be competitive on both the bid and the offer side; it tries to get inside both the bid and offer of the NYSE (1475). Mr. Weeden stated that he considers his business a service business which is dependent on inquiry from potential buyers and sellers. If a firm does not regularly quote good markets, it may find its customers will no longer call (1476). This is an important factor. Weeden has several well capitalized and active competitors (1475). It would classify 5-6 firms as major Third Market competitors (1498). Furthermore block positioning member firms, such as Goldman Sachs and Salomon Bros., perform the same function and thus compete with Weeden to the extent that they are putting up capital and assuming risk in principal transactions involving large blocks (1483).

Mr. Weeden stated that after hearing their earlier testimony, he felt that these firms made a lot more on their dealer transactions than Weeden does (1483).

The witness objected to the statement that the Third Market was dependent on the NYSE tape and that markets were being made around that tape. He stated that, if anything, the tape may complicate the process of making a market as it may lead the investor to expect the tape price even when it is not justified and even when it is well away from the price the New York specialist is quoting (1502-1503, 1491). He indicated that when the New York tape is late the firm tries to anticipate where the market is moving and may widen its spreads a little. In making markets in London, when U. S. markets are closed, Weeden works around the closing prices on the NYSE and the PCSE. It tries to maintain 500 share quotations in the London office (1503-1504).

The average dealer spread is 1/2 point on securities above $35-$40 per share although in certain securities the spread is somewhat larger (1479); on stocks selling at less than $35 they try to get 3/8 point. This price is net; the customer does not pay a commission (1479-1480). Actually, Mr. Weeden feels that even for the NYSE block positioning firms, who must charge a commission, the commission is not really a relevant consideration. The price is a negotiated price and the block positioning firm merely adjusts its price to take into consideration the fact that it will receive a commission (1485). Because of the minimum commission, the block positioning firms are able to develop a greater gross profit or lower price than Weeden can do under the competitive circumstances which exist. The witness said that after the commission is taken into consideration, however, the member firm's price is often less favorable to the investor than Weeden's price (1483). Mr. Weeden indicated that for reasons he did not understand, his firm is not exposed to business the firm feels it could compete for on a favorable basis in terms of price (1485).

The witness also discussed briefly NYSE trades in which Weeden participates with an NYSE member who has come to the firm with a block of stock at a good price, a practice which had slowed down since Rule 394(b) went into effect. Mr. Weeden pointed out that the customer would have gotten a better execution if he had come directly to Weeden. The firm's policy is to make the same bid or offer to an institution as it would to a broker-dealer. However, in dealing with the NYSE member firm, Weeden must pay a full non-member commission and will adjust its bid or ask to take this amount into account (1488-1490). The member firm's customer will accordingly pay more or receive less.

On odd lots, the NYSE last sale serves as a guide. The firm has advertised to banks and broker-dealers that it will automatically buy or sell odd-lots at no more than the odd- lot differential from the price on the last NYSE trade. This was compared to the practice on the NYSE with respect to odd-lots, i.e., next round lot price plus an odd-lot differential, plus commission (1480-1481).

The non-member broker-dealer or other intermediary, when dealing with the Third Market, will usually charge his customer the price quoted by the market maker plus a full commission. There was a short discussion of the practice whereby the broker-dealer, if the Third Market price is not competitive with the primary market, may request the market maker to bill him at the last public price plus a service charge. He will then absorb the service charge from the commission charged the customer (1490-1492).

As indicated earlier, Weeden acts as agent in about 10% of its trades. The usual practice is to charge 1/4 point on one side of the transaction in these cases. However, the charge does vary from case to case (1465-1466).

Give -Ups

This firm does not give up part of its dealer profits at the direction of customers (1481). In the 1950's a number of funds approached the firm to discuss the possibility of using Weeden to give up to non-member broker-dealers, but both groups decided such an arrangement was not appropriate (1497). Weeden does not feel a give up can be justified because of the negotiated character of its prices. If the firm were willing to give-up on a trade, it would be willing to improve its bid or offer by the same amount (1482).

In response to a question from the staff, Mr. Weeden stated that there are major fund complexes who do not do business with Weeden. He has discussed the matter with these companies and they have indicated to him that they do not do business with Weeden because the firm does not provide certain services, such as research, statistics and sales of fund shares. The funds feel they must use all their commission business to attract these services (1494-1495). However, Weeden 's largest single customer is a large mutual fund complex. This complex does not have a captive sales force (1495).

Policy

In response to a question concerning what effect the abolition of give-ups would have on his firm, Mr. Weeden stated that there were two schools of thought on that. If the funds felt that services now paid for through give-ups were essential, they would use direct executions and other means to satisfy these obligations, perhaps leaving even less business for the Third Market. If the services were not considered essential, there might, once give-ups are abolished, be more business available to seek the best price (1500). The implication was that this might increase the business of the Third Market.

Mr. Weeden indicated his firm did not oppose a volume discount but felt that it would certainly affect its business (1507).

Exhibits

Most of these exhibits relate to the share volume of stocks bought and sold, either by size of transaction or by type of customer. Exhibit No. 127 is a frequency distribution of Weeden & Co.'s business in October 1967 broken down by kind of customer, by number of trades and by size of trade. Share volume broken down by class of customer is given for the first six months of 1968 in Exhibit No. 128 and for June 1968 in Exhibit No. 125. The distribution of transactions by size of trade is given in Exhibit No. 130 for January to June 1968 and in Exhibit No. 126 for June only. Exhibit 129 was reserved for a list of the firm's ten largest customers, while Exhibit No. 124 was reserved for the figure giving the number of Weeden 's mutual fund customers.

DELAFIELD & DELAFIELD
Testimony July 19, 1968 -- p.p. 1599-1623

Introduction

Delafield is a member of the NYSE, Amex and PBW; it has brokers on the floor of the NYSE and Amex (1599,1600). The firm has 75 registered representatives; it has four branch offices in the U.S., also two overseas (1600). Simeon Dunlap Smith, who testified, is a general partner. Delafield concentrates principally on servicing institutional investors. Commissions for transactions for mutual funds totaled $550,000 in 1966 and $500,000 in 1967. Approximately 50% of these amounts was received from give-ups by check; Delafield states that most of these give-ups were mainly for research, give-ups for sales totaling $34,000 in 1966 and $21,150 in 1967 (1601). Delafield's direct commissions on mutual fund retail sales amounted to $108,438.42 in 1966 and $63,499.52 in 1967 (1601).

Relations with Fund of Funds

The testimony centered around Delafield's connection with the Fund of Funds. Commissions received from Fund of Funds and its affiliates on portfolio transactions are as follows (1602, 1612):

Gross Commissions

1965: $1,000

1966: $36,714 -- ($8,497 rec'd. as research giveups)

Jan. 1967 - June 1967: $83,648 -- ($76,151 rec'd. as research giveups)

July 1967 - June 1968: $4,923,272

In July 1967, Delafield hired as a registered representative Mrs. Gloria Clapp, a resident of Nassau, Bahamas, who brought the Fund of Funds business with her to the firm (1603). Mrs. Clapp, formerly with Jesup & Lament, had indicated to Delafield through a mutual friend, Mr. William Hitchcock, that she controlled the placement of Fund of Funds business; that she desired to change firms for "personal reasons"; and that she was interested in joining Delafield (1604). Smith first met with Hitchcock and with Mrs. Clapp's husband (1604); Smith met in Nassau with Mrs. Clapp herself (1605). Before hiring Mrs. Clapp, Mr. Smith confirmed her representations with Mr. Edward Cowett of Fund of Funds (1605-1606).

Delafield then hired Mrs. Clapp as a registered representative, and opened a resident office in the Bahamas (1606). Smith testified that she was hired to fulfill the normal functions of a registered representative, that she was under Delafield's supervision, and that she had several accounts besides Fund of Funds (1607-1608). Smith had no precise knowledge of her relation with Fund of Funds; he did know it went back several years. He also testified that he believed Mr. Cowett and Mr. Clapp had been friends since college, but that he knew of no other connection between them (1607-1608, 1619).

Most of the Fund of Funds business with Delafield was clearance. Fund of Funds would send all orders through Arthur Lipper. Lipper would give the order to one of six firms (sometimes Delafield) for execution with instructions usually to give up Delafield's name for clearance (1609, 1610). Even though Arthur Lipper named Delafield to clear, Lipper as well as Delafield is a member of the New York Clearing Corporation (1623).

Mrs. Clapp received 70% of the Fund of Funds commissions paid to Delafield after floor give-ups had been subtracted from the gross. Out of pocket expenses were subtracted from Mrs. Clapp's 70%. Mr. Smith estimated she actually received 55% of the gross. Payments to Mrs. Clapp were made through Delafield's Account at First National City Bank through the Bank of Nova Scotia to the account of Mrs. Clapp at the Bank of Nova Scotia, Nassau (1615-1616, 1620).

Mrs. Clapp severed her relations with Delafield on July 3, 1968. Between July 1967 and June 1968 she received $2,749,563 in commissions for Fund of Funds business; total commissions she received during this time were $3,080,012. Mr. Hitchcock received 5% of the gross Fund of Funds commissions, and a Mr. Stephaich, who claimed a role in introducing Mrs. Clapp to Delafield, received a one-time lump sum of $20,000. The gross amount retained by the firm from Fund of Funds commission during the period of Mrs. Clapp's employ was $1 1/2 million (1616, 1618).

A letter from Bear-Stearns to Delafield directing a $10,000 give-up check to Mrs. Clapp was introduced into the record. Mr. Smith stated he had no knowledge of the transactions involved (1622). At one point, Mrs. Clapp requested that Delafield contribute to a charity favored by the manager of Fund of Funds. Delafield made no donation. Mr. Smith stated that he believed Mrs. Clapp donated $100,000 on her own (1621).

<u>Exhibits</u>

Exhibit 162 is a record of Mrs. Clapp's compensation from Delafield; Exhibit 163 contains transmittal letters to banks for Mrs. Clapp's compensation. Exhibit 164 shows a $10,000 give-up directed by Bear-Stearns to Mrs. Clapp through Delafield.

<u>**MAXWELL OHLMAN & CO.**</u>
<u>**July 19, 1968 -- pp. 1624-1710**</u>

<u>INTRODUCTION</u>

Mr. Maxwell Ohlman, a major partner in Maxwell Ohlman & Co. (Ohlman & Co.). testified.

Ohlman & Co. is a member firm of the Philadelphia-Baltimore-Washington Stock Exchange, and an associate member of the Boston, Montreal and Pittsburgh Stock Exchanges (1624). Ohlman & Co. is a member of the clearing corporation of the PBW only. It does not have a floor broker and does not act as specialist on any of the exchanges. Harry Dackerman and Company is the floor broker that Ohlman uses on the PBW (1625).

Ohlman & Co. has only one other partner: the wife of Mr. Ohlman. The firm has 15 to 17 full-time employees but no registered representatives. The firm's salesmen sell only services and thus do not need to be registered (1626). No individual investors are customers of the firm.

In 1967, the firm's gross income was about $242,000. This figure includes $168,000 which came from orders which the firm received and executed on the PBW through Dackerman and Company; in effect, on these orders, Ohlman's name was given up for clearance (1628).

The services that Ohlman & Co. perform include the preparation of sales literature and sales training courses, and the writing of stockholder letters (1629). The firm also monthly publishes news and advice for mutual fund management distributing companies (1629).

Exhibit 165 is a brochure entitled "The Ohlman School of Finance" which shows all of the courses and services offered by the Ohlman & Co. It includes a course which is a training program for the NASD and SECO examination (1630). The charge for this examination course is either $65 in cash or $225 in directed commission business (1631). If a broker uses Ohlman's sales training program or examination preparation course, he can pay in commissions by either placing orders with Ohlman & Co. in which the total amount of commission would be $225, or, if he is entitled to receive reciprocals from a fund, by having that fund direct business to Ohlman or to someone Ohlman designates. Ohlman's designees usually are from a particular group of about forty firms, most of whom are New York Stock Exchange members (1632). If a broker decides to pay in commissions rather than in cash, it has up to 6 months to direct commission business to cover its purchase. All listed and over-the-counter commission business is accepted in payment of service.

An other service that Ohlman & Co provides is a series of letters to reactivate delinquent" accounts. The customers for these letters are primarily sponsors of contractual plan companies (1636). The firm also does custom tailored work for mutual fund sponsors, such as public relations, corporation value reports, shareholder letters and sales literature. It also prices portfolios, furnishes data processing services, and offers services published by the Institute for Business Planning. The firm also loans standard financial publications (1637). Some of these services are subcontracted and some are performed by the firm itself (1637). For these services also, the customer has a choice in paying in cash or brokerage; the cash amount would be either a third or a quarter of the amount of brokerage required to pay for the services (1639).

Mr. Ohlman also owns Information and Research Services Incorporated (IRS), a registered investment advisory service. This firm has approximately eight full-time employees: three of them are members of the Ohlman family and the other four or five are consultants who are paid for work on a piece-by-piece basis (1640-1641). The services that Information and Research Services sells include the Rinfret Services, the Equity Research Services, the Ferguson Charge Service, the International Metal Service, the International Oil Service, a market review, an economics series, "Washington Ahead of the News" series, individual company reports, stocks in the news, general comments, purchase recommendations, and also the Maxwell Ohlman publication, "News and Views Service" (1641). Several of these services are purchased from other organizations and then resold by IRS to its clients (1642). IRS sells this complete package or a modified version of it depending on the needs of the customer (1642). The full package costs $2,500 a month; modified versions cost less (1640). Customers for the service are primarily about forty member firms of the New York Stock Exchange. About thirty of these firms buy the complete package. All of these services are paid for in cash. Exhibit No. 166 shows that Merkin & Company is a customer of IRS and gets the monthly package at $2,500 a month. First Hanover Corporation is also a customer and gets everything but Equity Research Service for $2,200 a month.

Ohlman & Co. uses brokerage commissions to pay Equity Research Services. Equity Research Services is a NYSE member, and accordingly, IRS, when it has the opportunity, will direct either brokerage or give-ups there to Equity Research (1645-1646).

The services that Ohlman or IRS sub-contract (such as those from Equity Research) are stamped and distributed by IRS and are mailed directly either by the sub-contractor or by IRS. Approximately 5570 (or $1,300 worth) of the entire package is sub-contracted. The entire package purchased individually by item, would cost approximately $3,200 a month (1647). Mr. Maxwell Ohlman is also the sole stockholder of Columbia Management Consulting Corporation (Columbia). Columbia has one client, Robinson and Company(a NYSE member firm located in Philadelphia) (1649). Services provided by Columbia include executive and sales recruiting, management consulting, psychological testing, and office planning and layout. Columbia sub-contracts all of its work; it has no employees. Columbia subcontracts its executive recruitment work to Ashley Blake (Philadelphia), its office layout work to Techtonics (New York), and its psychological testing to Chandler Drake (Philadelphia). Columbia also offers Ohlman's personal services in the area of sales promotion and sales training in the mutual fund field. Columbia's billings to Robinson and Company have amounted to $335,000 since its inception in March, 1967 (1651).

Commission Exhibit No. 168 shows an example of the Ohlman billing system. In this particular case, a bill was sent to Robinson in the amount of $25,062.50. It contained an item for initial work in developing an organization chart which came to $8,032,50. This particular piece of work had been sub-contracted out to Ashley Blake, who performed the work and billed Columbia for $3,622.50. The markup to Robinson & Company was therefore approximately 150% (1654-1655). Similarly, Commission Exhibit No. 169 shows a bill to Columbia from Techtonics for $410, and a subsequent bill covering the same contract to Robinson &

Company from Columbia for $2,050 (1656-1657). Commission Exhibits No. 170 and 171 show bills sent to Robinson and Company reflecting 500% mark-ups. Commission Exhibit No. 173 is a bill to Columbia from Chandler Drake for psychological testing. Columbia Management, which was charged $10 per person, charged Robinson and Company $100 per person for this test (1660). Columbia Management did not mark up the bill to Robinson and Company for executive recruiting (1661). Ohlman stated that Robinson has checked competitive prices in the Philadelphia area and that despite the size of the markups, Robinson states that he is paying less than he would through some of the other firms in Philadelphia (1662).

Ohlman is able to direct brokerage to the New York Stock Exchange firms that pay for Ohlman service in cash. Ohlman requests institutional investors to direct brokerage or give-ups to Ohlman's designee (1664). Commission Exhibit 174 is a list of New York Stock Exchange member firms that subscribe to IRS. Two customers that are not New York Stock Exchange member firms are Dreyfus Corporation, a management company, and Federated Investors (1666). A list of these firms is furnished to anyone who is doing any large volume of business with Ohlman and who wants to direct business to Ohlman or to one of Ohlman's companies, via the NYSE give-up route (1668). For example, the firm of Mezarow & Company is on the list. This firm will receive approximately $2,500 per month in give-up checks just the amount that it pays for IRS services (1669). Ohlman & Co. is fairly successful in directing give-ups to its customers in an amount approximating the amount that these customers pay in cash for Ohlman's services. Ohlman would prefer getting paid by commission business placed on the PBW where it is a member, but this is not practical (1672). In the case of Gerstley Sunstein, Ohlman swaps Big Board business for PBW business in lieu of directing give-ups (1670).

The fund managers are willing to direct give-ups to Ohlman's designees because of services Ohlman's firm provides them (1673). The primary service Ohlman & Co. supplies is its ability to direct dollars to mutual fund sellers who are members of the NASD only or to mutual fund sellers outside the United States who are not members of the NASD (1674). The mutual fund dealers bill IRS for sales assistance and receive a check-in payment (1674). Commission Exhibit 176 is a series of bills received by IRS for sales assistance. For example, Foreign Dealer Selective Investments (Bahamas) billed Columbia Management Consulting Corporation. FDSI had been selling fund shares for Anchor Corporation, and was entitled to reciprocal business from Anchor. FDSI told Anchor to direct this reciprocal business to Robinson a client of Columbia management. This facilitates Columbia Management's doing business with Robinson since it lowers Robinson's cost (1675-1676). Ohlman gets the names of these foreign dealers either from the dealers themselves, who may come in to see him personally, or from the fund (1677). Ohlman sends money to approximately 12 foreign dealers for sales assistance. Among these are Pearl Mutual Investments, Ltd. (Hong Kong); International Securities Corporation, Ltd. (Madrid); Stan Corporation, Ltd. (Bahamas); Colonial Securities of Boston, (Brussels); Zas Weis (Germany); Trans World Finance (Nassau) and Investment Dealers Corporation (Panama). These firms are shown in Commission Exhibit No. 179 (1680-1681). If Ohlman pays, for example, $1,000 to a dealer who sells fund shares, the fund management company either will direct from $2,000 to $3,300 in give-up checks to an Ohlman designee (1682), or will direct brokerage to a specified New York Stock Exchange member firm (1681).

Brokers selling fund shares of Value Line Securities do not bill Ohlman directly for sales assistance. Instead, Value Line bills Ohlman on behalf of the brokers who have sold shares, and then pays those brokers itself (1684 and Commission Exhibit No. 181).

On April 17, 1968, Columbia received a bill for $10,000 in sales assistance on the letterhead of Salig & Co.; it subsequently paid the bill (1685-1686). Salig & Co. is a broker-dealer NASD member and a principal underwriter for Republic Technology. Ohlman & Co. claims that at the time this bill was paid it was not aware of the relationship between Salig & Co. and Republic Technology, even though the letterhead of Salig & Co. indicates that it is a principal underwriter for Republic Technology (1687). Mr. Ohlman stated that, on the advice of counsel that the fund prospectus does not permit such a payment (1688). his firm does not pay an NASD dealer where such a relationship exists. This legal advice was received prior to the time that Salig & Co. sent the bill, and Salig & Co. would not have been paid if Ohlman & Co. had known of the relationship (1687). Commission Exhibit No. 183 is a chart which traces a transaction from Ohlman & Co. through to an NASD dealer. A New York Stock Exchange member has purchased and paid for $1,000 in services from one of Ohlman's companies. Ohlman tells Crosby Corporation, principal underwriter for Fidelity Funds, to direct $1,000 in give-ups to the NYSE member. The NYSE member then receives either $1,000 in give-ups or in direct brokerage business and, under the label of sales assistance, Ohlman sends $500 to a broker-dealer designee of Crosby who has been selling Fidelity Fund shares (1688-1690).

At the request of a fund manager, one of Ohlman's companies has paid part of a fund's expenses. In one case it paid the printing expenses for Hubsman Fund. The fund's prospectus allowed the fund to use brokerage to lower the cost of the operating expenses (1691). In another case, one of Ohlman's companies paid money to the underwriter of Consumers Investors Planning. This practice, as in the Salig case, has been discontinued.

Another service provided by one of Ohlman's companies is paying the rental on a Bunker Ramo Telequote machine for E. W. Axe & Co., (investment adviser of the

Axe Funds). These payments were made after counsel had apparently checked the prospectus and approved of the transaction (1692). Commission Exhibit No. 184 shows the bills from Bunker Ramo Corporation which reflect these transactions. The bills begin in September, 1967 and continue up to the time of Ohlman's testimony. To compensate Ohlman for paying these bills, E. W. Axe & Co. directs brokerage either to Ohlman or to firms that Ohlman designates (1694). The designee pays this money back to Ohlman purchasing IRS services or through some other route. Generally for each $1.00 that is paid for Bunker Ramo rental, Ohlman receives back $3,33 (1695). This series of transactions is shown in a chart marked Commission Exhibit No. 185.

Commission Exhibit No. 186 is a list of Ohlman's clients for various services. It also indicates how Ohlman receives payment from these clients for the services. Some clients receive services on a complimentary basis, some pay in cash, and others pay in commission dollars (1696). Fidelity Fund pays in cash. Channing Corporation, Financial Programs, Inc. (a distributor for FIF), and IOS management Co. pay in commission dollars (1698-1699). IOS commission dollars are sent through Arthur Lipper & Co. Mr. Ohlman stated that he does not know whether these dollars arise from IOS funds or not (1699). Other fund manager-underwriters who subscribe to Ohlman's services are: Lexington Research and Management Corporation, National Securities and Research Corporation, and Oppenheimer Funds (1699-1700). Oppenheimer Funds pays in cash rather than portfolio brokerage. Putnam Management Company and Stetman Securities Corporation, a fund manager, pay in commissions. Van Strom and Town, which is an investment counsel firm and part of the Channing Mutual Fund Complex, pays through commissions.

Ohlman swaps business with Dishy Easton. Ohlman gives Dishy American business and Dishy returns business via the PBW. Ohlman stated that a $12,000 check was received from Michael J. Heaney & Company in relation to commission swapping business. Commission Exhibit No. 187 was reserved to confirm this; it has been received and does confirm Mr. Ohlman's statement.

Commission Exhibit No. 188 is a list of the ten mutual fund complexes for whom Ohlman paid out the most for various services (including sales literature, expenses, and sales assistance) (1702). In the case of Colonial Funds, for every $2 in New York Stock Exchange give-up that was directed to Ohlman clients. Ohlman provided $1 in services (including sales assistance and literature for dealers who sold shares of Colonial Funds. (1702-1703). The dollar amount involved here was $63,000 in 1967, and about $31,500 for the first six months of 1968. In the case of Crosby Corporation, the dollar amount involved was $442,000 in 1967 and about $459,000 for the first six months of 1968 (1703-1704). These figures mean that of the $459,000 paid by Crosby, at Ohlman's direction, Ohlman paid dealers one-half of that amount either at the request of

Crosby (or Fidelity Management) or at the request of the seller of the Fidelity Fund shares.

Financial Programs is also among the ten leading funds; it receives services in the form of sales literature and custom-tailored public relations (1706). Keystone, Provident Fund, and Hugh W. Long (which is now known as the Anchor Corporation) also appear on the list; they received sales assistance. Ohlman also provided annual reports for Manhattan Fund. In all of these cases, $1 in services resulted in $2 in give-ups.

Ohlman does not always check with the fund manager before paying the bills for sales assistance that it receives (1705). However, Ohlman does not pay a bill unless it expects that Ohlman will be compensated in reciprocal commissions or give-ups (1706).

In summary, Ohlman provides the mutual funds managers with a method of using their control over the portfolio brokerage business and the resultant flow of commissions as substitute for cash in purchasing miscellaneous services, some of which Ohlman supplies and some of which are sub-contracted. Ohlman is hopeful that the New York Stock Exchange member firms who purchase his services will be able to do so without cost or at a very minimal cost.

ANCHOR CORPORATION
July 22, 1968 -- pp. 1711-1827

Mr. John Haire, Chairman of the Board of Anchor Corporation, testified. Anchor Corporation (Anchor) is the manager and underwriter for the Anchor Group of Mutual Funds, consisting of five mutual funds with assets of slightly more than $2 billion. Anchor has approximately 175 employees; 50 are in investment management, 30 of these being "professionals." The unaffiliated directors are identical for each of the funds. All of the funds utilize a common trading department consisting of two traders and three clerks.

The funds use a small number of primary brokers to execute the bulk of their orders. These brokers are all members of the NYSE and at least one regional exchange. The major primary brokers used for NYSE execution are Demsey Tegler, Eastman Dillon Union Securities, Paine Weber, Jackson and Curtis, and Reynolds and Company. For executions on the PCSE Anchor uses California Investors and First California Co.; on the Midwest Stock Exchange it uses First California and Illinois Co.

Anchor defines "primary broker" to be one willing to give-up a percentage of his commission. The primary and executing brokers may be, but are not necessarily, the same. For example, on the PCSE the executing broker might be Jefferies & Co. executing for 10% and giving up 90% to a primary broker (perhaps in this instance California Investors) who will send the confirmation. Primary brokers have the responsibility for clearing and confirming the transaction yet in all cases agree to give-up 60%.

The witness testified that Jefferies is doing a completely satisfactory job for 10% of the commission [at p. 1738 the quote reads 10% of the floor brokerage -- this should read 10% of the commission]. Principal lead brokers used on the PCSE other than Jefferies are Mitchum Jones, Noble Cook, Westamerica and J. P. Cohn. In all, Jefferies and Mitchum Jones perform the great bulk of PCSE executions.

Use of Regional Exchanges

The witness testified that there are three reasons for taking a cross to a regional exchange: First, to avoid the New York Stock Transfer tax; second, to obviate disruption of the cross by previous orders on the specialists book in New York; and, third, the liberal give-up rules of regional stock exchanges. Questioning elicited that the first reason is not actually considered by the manager and that the liberal give-up rules is the primary reason. Thus Anchor does not generally do business on the Midwest Stock Exchange because it lacks a liberal give-up rule. Apparently Anchor does not attempt to clean up the book on the NYSE before taking a cross to a regional. Anchor's total commission business on all national securities exchanges during 1967 was distributed as follows: 58.5% on the NYSE; 25.3% on the PCSE [30% of Anchor's sales are in California and 25% of brokerages is on the PCSE]; 6.4% on the Midwest Exchange; 5.9% on the PBWSE; 2.6% on the Boston Exchange; .7% on the Amex; .4% on the Detroit Exchange; and 2.2% in the over-the-counter market. [This includes third market market transactions although the testimony indicated that Anchor's use of the third market is not significant (1803-1807).]

Allocation of Give-Ups for Sales

The witness testified that Anchor distributed give-ups to particular dealers according to their sales of the entire group of Anchor funds. The underwriting agreement between Anchor and the funds permits the underwriter to request a fund to place a reasonable portion of its portfolio orders with brokerage firms designated by the underwriter. Generally 80% of the commissions generated by a fund's portfolio executions are allocated to fund share sellers. Anchor is able to send compensation to some sellers by utilizing the PCSE preferred rate member system to direct reciprocal business.

A seller of Anchor funds can expect to receive 3% to 3.5% of the total dollar amount he sold, through given up commission dollars. Of the total fund share sales in 1967, 63.8% were by NYSE members, 25.5% by regional only members and 7.7% by NASD only members. For the first six months of 1968 the comparable figures were 66.4% by NYSE members, 23.2% by regional only members and 10.4% by NASD members.

Testimony indicated that Eastman Dillon has been receiving approximately three times the reciprocal business received by other sellers of fund shares; this can be attributed to the services they perform: quotes, block positioning, and other intangibles not related solely to its sales effort. Fundamental does not allocate any brokerage solely for execution. 84% of the available commission dollars was allocated for sales and 16% for research. Anchor directs give-ups to only a few block positioning firms.

The second largest seller of Fundamental Investors is Intertrust S. A. (Anchor owns 30% of Intertrust.) Intertrust is an exclusive distributor for Fundamental Investors in Europe and portions of the Near East; it does not sell the shares of any other funds. The funds sell to Intertrust at net asset value, rather than the domestic dealer discounts (offering price minus dealers compensation) and Intertrust retains the full sales charge. The funds do not give any reciprocal commissions to Intertrust. It does not receive reciprocal business since it is affiliated with Anchor and since the sales load is high.

In 1967 California Investors was the third largest seller of the largest fund, Fundamental Investors. It was also a major seller of Diversified Growth Stock Fund.

First Investors Corp. does not receive any reciprocal business, yet it is the fourth largest seller of Fundamental Investors. It sells contractual plans based on Fundamental and Diversified Growth Stock Fund shares. First Investors owns 7,008,200 shares of Class C Anchor Corporation stock; therefore, it receives a share of Anchor's profits.

Selective Investments, a foreign dealer of Anchor funds, received compensation through Maxwell Ohlman & Co. Anchor did not know how Maxwell Ohlman & Co. was able to channel commission dollars to Selective Investments, but pursuant to this arrangement it directed $76,000 in the last year and one-half to 17 NYSE firms.

Allocation of Give-Ups for Research

Apart from designating give-ups to reward or encourage sales of fund shares, Fundamental Investors and Growth Stock Fund also directed give-ups to compensate for corroborative research not compensated by the management fee. The witness maintained that sums paid for research through give-ups were contemplated by the management contract but that the management fee compensates only "in-house research."

In addition to the total advisory fee of $8 million paid to the manager in 1967, $1.3 million in commission give-ups were paid for research. Anchor conceded that they would not spend nearly so much if they had had to pay in cash. Of the 150 firms used, such institutionally oriented research firms as Glore Forgan ($10,000), Donnell ($900), Lazard Freres ($1,000), Loeb Khoades ($8,000), and Walter Delafield ($12,000) received only nominal sums. The largest compensation, $32,000, was given William O'Neil because "he has been doing some very imaginative work with computers in the field of investment research."

The witness justified the give-up device and utilization of regional exchanges with several contentions. He thought that one must look at all exchange markets together as a single broad market place; thus regional exchange trades do not undermine the liquidity of the New York market. The witness felt that a fund shareholder benefits from an increase in sales in two ways: (1) management fee is scaled down; and (2) the manager will be able to enlarge the scope and depth of his management service over the years. It was shown, however, that it does not aid the shareholder of Fund A to have the management fee of Fund B reduced by an increase in sales compensated with brokerage generated by Fund A portfolio transactions. (The only way this might be a benefit to the shareholder is with a "Keystone" fee arrangement where all the fee money is pooled before use.) Furthermore, although Fundamental Investors was in a period of net redemption the management did not use Fundamental Investors brokerage to correct that condition; rather, at this time, the management was using the available brokerage to reward the sale of Growth Stock Funds. Apparently the reason was because prior to April, 1968, when Growth Stock Funds passed the last break point on its advisory fee schedule, the fund manager received a higher management fee (i.e., a higher percentage of net assets) for sales of Growth Stock Funds than for sales of Fundamental shares.

Recapture of Available Brokerage

The witness was asked why management does not direct commission dollars back to the funds and he replied that this would be an artificial device to do indirectly what should not be done directly. On the other hand, it was not thought artificial to direct commission dollars to the sellers of the fund shares. When asked why Anchor, when participating in a tender offer of securities in their portfolio, let the broker retain the tender solicitation fee, and did not attempt to direct the fee to Anchor to reduce its management charge s the witness replied that this could not be done "without having the shareholders create a whole new contract." He thought that any time the management attempted to give money to the shareholders a new contract would be required. The witness stated he was apprised in 1966 of methods by which he could return commission dollars to reduce management fees.

He testified that fund directors are fully aware of these methods and have advice from independent counsel. He did not know if the independent directors and their counsel had discussed this issue. One major reason for their reluctance to return commission dollars is possibly a resulting competitive disadvantage. The witness testified that he was not aware of a workable method for a volume discount. To be successful, any such method must leave the institution free to use its best judgement in seeking the most favorable execution of an entire order and not risk hindsight allocation. Moreover, the order must be handled in such a way that the commissions are not reduced to a minimum. The witness thought that the 19(b) volume discount did not meet those criteria.

The witness further testified that abolition of give-ups might mean shrinkage of the number of brokers who execute orders; this, despite the fact that Anchor now uses only a half dozen brokers while using 30 to 40 about six years ago.

The witness testified that generally it is in the best interest of institutions to encourage the broader ownership of securities and avoid ... concentration of the brokerage business in the hands of fewer and fewer [brokers]." Apparently, the witness is saying that commissions paid by mutual funds should subsidize small broker dealers. The witness seems to suggest that if give-ups were abolished many small dealers would go out of business or would merge with larger firms (1800). They need the extra income that the give-up produces to stay in business.

Summary

Anchor Corporation presents a basic, unsophisticated example of the use of the give-up technique to reward and compensate sales and research. Anchor does not need complex devices since it has a "concentrated" selling organization of approximately fifty broker-dealers, who, almost without exception, are members of regional stock exchanges. The fund managers have little difficulty in directing commission dollars to these dealers.

It is also important to note that Anchor's method of compensating fund share sales contemplates the use of give-ups generated by portfolio brokerage of one fund to reward the sellers of another of the funds it manages. Moreover, in the instance recorded in the testimony, this was apparently done solely to increase the management fee.

Exhibits

Exhibit # 189 (Described on page 1729) is a table which shows for 1966, 1967, and 1968 the dollar value and percentage of portfolio executions done on the various national securities exchanges by the group of funds which are managed by Anchor Corporation.

Exhibit # 190 (Described on page 1756) is a breakdown of the dealers who sell Anchor Fund shares broken down by membership on national securities exchanges.

Exhibit # 191 (Described on pages 1787-1791) is a letter from John Hare, President of Anchor Corporation to the Securities and Exchange Commission, dated November 3, 1966, on the subject of a then proposed volume discount.

Exhibits # 193-196 are reserved for information to be supplied by Anchor Corporation.

FIDELITY MANAGEMENT & RESEARCH CO.
July 23, 1968 -- pp. 1828-1964

Introduction

Fidelity Management & Research Co. (FMR) advises and conducts the investment activities of twelve investment companies. FMR was established in 1936, apparently to manage the Fidelity Fund formed in 1930. Subsequently FMR formed nine investment companies and accepted management of two companies independently formed (1833-1834). Of the twelve funds managed by FMR, the four largest are: Fidelity Trend with $1.3 billion in net assets; Fidelity Fund with $832 million in net assets; Fidelity Capital with $740 million in net assets; and Puritan Fund with $719 million in net assets (1833). FMR is not registered under the Investment Advisers Act; its wholly-owned subsidiary, Crosby Corporation (Crosby), the principal underwriter for the funds under FMR's management, is a registered broker-dealer and a member of the NASD. (Crosby also serves some non-investment company clients comprising $165 million in total assets.) (1834-1836)

Operation of the Management Company

The President, the Executive Vice President and the Treasurer of FMR are principals in each fund complex. The President and the Executive Vice President are also directors of the Crosby Corporation. The Chairman of the Board of Crosby is a Vice President of each of the funds. The directors of each fund are the same except for an occasional unaffiliated director with particular funds. All officers are paid by the management company, FMR (1836-1837).

The management and advisory fee schedule varies with each fund; for example: Fidelity Trend and Fidelity Capital Fund pay a fee of .0050% for the first $200 million in assets, .0045% for $200 to $300 million, and .0035% for over $300 million; Fidelity Fund has a fee of .0050% for the first $200 million in assets and .0035% after that. Puritan Fund, however, which "emphasizes income with some growth of capital," has a fee schedule lower than the others, beginning at .0040% and graduating to .0038% and .0035% (1839-1840). The funds paid $13.9 million in total management fees on $4 billion aggregate fund assets managed by FMR (1337-1338). Certain expenses are not paid by FMR but are paid by the funds themselves; to wit: transfer account fees, custodian fees, expenses of reporting to shareholders, printing costs and portfolio brokerage (1840). On the other hand, salaries of employees and officers of the fund, and the cost of the common trading department (four traders, one trainee, and one clerk) are borne by FMR (1840-1841).

Execution

The selection of primary or lead brokerage firms to execute fund portfolio transactions is based upon the ability of the broker to execute transactions efficiently. Thus, "a very substantial portion" of transactions are executed by certain member firms (of the NYSE) even though they do not sell mutual fund shares (1848). When questioned why FMR uses firms other than the wire houses who sell mutual fund shares, FMR replied: "We have to go where the best market is" (1849). Firms such as Goldman, Sachs, probably because they block position, are able to indicate daily to FMR blocks that are wanted or available (Id.).

9.6% of the total commissions paid out by FMR in 1967 were on third market transactions (up from 6.9% in 1966) (1845). Although normally dealing as a principal in the third market, FMR determines a commission figure for statistical and bookkeeping purposes, arbitrarily using the value of one quarter of a point. [See transcript July 23, 1968, 1828-2051 at 1842 for the ten brokerage firms, in terms of commission dollars, utilized most by FMR in 1967; at 1843, 1846, 1846-1847 for the ten broker-dealer firms utilized most, in terms of gross value of shares traded by Fidelity Fund, Fidelity Capital Fund, and Fidelity Trend Fund (for the first six months of 1968).]

Allocation of Commissions

FMR utilizes the give-up allowances of regional exchanges (normally Boston, Detroit and Pacific Coast) to compensate NASD only members and foreign dealers for Fidelity group sales (they combined for 37% of the total Fidelity group sales in the first 5 months of 1968) (1866). Certain lead brokers, who execute fund portfolio orders on the exchanges, will give up a portion of their commission to broker-dealers designated by FMR.

Typically 60% is given up by the lead broker; the percentage is higher on the Pacific Coast Stock Exchange, which permits give-ups of 70%, and is lower for one broker, an NYSE member, who refuses to give-up more than 50% (1850, 1856). The give-up dollars are actually paid out to the designated broker-dealer; thus some wirehouses who sell FMR group shares and who also execute FMR group portfolio transactions both pay out and receive give-ups (1853). A wire house may not be active in any given month in executing fund orders yet may receive give-up checks for performing other services, for example, supplying research and statistical information (1854). The more constant recognition of this research service, however, is by direct business to the broker-dealers providing such information.

Mr. David Pierce, a salaried assistant to the treasurer, is responsible for determining the amount of commissions available and its allocation; thus, although information is directed to Mr. Pierce by Mr. Sullivan, Mr. McEwan and Mr. Burns, the final decision to direct a give-up to a particular broker-dealer is not that of a senior policy maker (1925-1927).

A broker-dealer will normally receive, through give-ups and/or reciprocal business, 1.5% of the amount of fund shares sold by him (1863-1864). [The names of dealers and of certain foreign dealers selling the greatest dollar amount of the Fidelity group shares for the first six months of 1968 appear in the transcript at 1859-1862. This list includes firms that are not members of an exchange and who have not received any give -up commissions generated by the Fidelity group portfolio brokerage.]

FMR has suggested to two fund share dealers, R. L. Stewart of San Antonio and Marshall Co. of Milwaukee, that they join the Midwest Stock Exchange enabling them to receive give-ups; they joined Midwest shortly thereafter (1856-1857). Although some members of the NYSE refuse to give-up a portion of their commission when directed to do so by FMR, none of the primary brokers has ever refused (1858). Nonetheless, at times no give-up is expected; for instance, the positioning of a large block may be a valuable service to a fund manager and he might not require the primary broker to give-up a percentage of the commission generated by the portion of the block not positioned (1859).

The testimony revealed two other methods utilized by FMR to channel compensation to sellers of its fund shares. In one instance, FMR requested that a dealer in its shares, S. J. Lind, Inc., be included as a selling group member in an underwriting venture. FMR knew it would be participating in a tender-offer by actually tendering stock of the Fidelity group, has requested broker-dealers to send a portion of the tender solicitation fee to a firm that is a seller of FMR fund shares (1951).

A typical prospectus, for example that of Fidelity Capital, states that 42% of the total commission dollars paid out is given up for sales and 8% is given up for research (1952-1953). The 8% is in addition to the usual method of compensating research efforts, i.e., placing an order directly with the research company. Some portion of the 50% total given up for sales and research goes to firms that both sell fund shares and/or contribute research and who also execute the fund portfolio transactions (1952-1953). Testimony also indicates that at least two methods of giving up were definitely not reflected in the books and records of FMR as give-ups: (1) a fund will execute an order with an NYSE broker and that broker will bring unrelated trades to a regional exchange in order to give-up clearance to a sole member of the regional; (2) an NYSE broker will give-up on a fund portfolio transaction to one of its correspondents (1869).

Apparently it is sometimes difficult to channel adequate compensation to the NASD-only members through these devices. In one illustration given, 50% of a commission available on a regional exchange could have been given up to NASD-only members, however only 10% was actually diverted to them, the balance going to NYSE members (1867). This occurred in spite of FMR's stated intention to maximize utilization of the regional exchange give-up rules in order to channel funds to non-NYSE members (Id.).

Arrangements with Stifel, Nicolaus & Co., Boettcher & Co., and Maxwell Ohlman & Co.

For two and one-half years FMR had an arrangement with Stifel, Nicolaus & So. (Stifel). an NYSE member firm. FMR directed give-up dollars generated from fund portfolio transactions, to Stifel, which Stifel would then pass on to NASD dealers selling FMR managed fund shares by purportedly splitting commissions on Stifel's unrelated over-the-counter (OTC) transactions (1870-1874). Pursuant to this arrangement, $717,000 in give-ups from portfolio transactions of Fidelity Capital, Fidelity Trend, Puritan, and Dow Theory Funds, were directed from lead brokers to Stifel in 1966 (1870). $360,000, or 50%, was redirected to NASD-only dealers (but not foreign dealers) by Stifel. A similar arrangement was devised with Boettcher & Co. to distribute give-ups of NYSE commission dollars to NASD-only members.

On September 15, 1966 this arrangement was questioned by an FMR officer, stating: "[I]n view of the SEC's increasing concern with mutual fund practices involving give-up commissions I would urge that we review the practice we have been following with Boettcher and Stifel." The arrangement with Stifel was terminated on January 1, 1967 when FMR concluded "it was unethical" (1874). FMR had recognized that customers of the FMR group of funds might infer that the Fidelity group had been participating in the OTC transactions (1875).

Moreover, the arrangement with Stifel, quite apart from any ethical consideration, proved to be an inefficient and expensive utilization of the commission dollar (1876). A lead broker pays out 60% of its commission at the direction of FMR to Stifel; Stifel in turn gives up 50% of this money received to NASD dealers: thus, of the gross commission dollar the non-member NASD dealers received only 30%. On the other hand had business been placed on, for example, the Detroit Stock Exchange 40% could have been given-up directly to the non-member NASD dealers (1876-1878).

In September, 1965, Mr. David Lawrence, a Senior Partner of Boettcher & Co. (a member of the New York, American and Midwest Stock Exchanges and a "reasonably large volume seller" of FMR managed funds) approached FMR with a new plan to aid FMR in compensating certain NASD dealers for their sales of the FMR group of funds (1880-1881). FMR would direct give-up checks to Boettcher & Co. and Boettcher & Co. would pay out 50% of that amount to NASD dealers who were not members of an exchange, allegedly for municipal financing information given by said dealers to Boettcher & Co. [These dealers were not experts in municipal obligations but were close to city administrations and could provide information and introductions (1887).] The list of dealers was subject to revision by Boettcher & Co. and, in fact, of the first list submitted, "5 or 6 of those 25 or 30 were unacceptable to Mr. Lawrence" (1882).

If Boettcher & Co. became dissatisfied with a dealer, FMR would comply with Boettcher's request not to direct any more give-ups to that dealer; but FMR would not attempt specifically to enlist a reluctant dealer's cooperation in providing information for Boettcher & Co. (1883).

Pursuant to this arrangement $510,000 was given up to Boettcher & Co. in 1966, $842,000 in 1967, and $420,000 in the first five months of 1968. Boettcher & Co. kept 50% until "about a year ago" when they agreed to give-up 60% (15%, however, of what Boettcher retained on this municipal bond service would be credited to their sales of mutual funds) (1884-1885). Foreign dealers did not participate in the total $1.75 million given up to Boettcher & Co. until August 1967, when Boettcher indicated to FMR that they would be willing to redirect give-ups to foreign sellers of the FMR group of funds, who would, in turn, provide Boettcher & Co. with "a good store of information regarding foreign mutual fund sales, laws, regulations, etc. all to the end that Boettcher & Co. would be well equipped to make a major move in foreign sectors. ..." (1885-1885). FMR was willing to participate in this plan since it was another method of "indirectly" taking advantage of NYSE commission dollars which it could not "directly" utilize. (1919)

The testimony indicated that the arrangement was questionable, in main since it appeared that neither the quality nor the quantity of municipal financings information mattered to Boettcher or FMR. For example, although Boettcher & Co. was itself located in Denver, Colorado and presumably could get municipal financing information about Denver for itself, it paid out money to two Denver NASD dealers, Kelly & Morey, and Coughlin & Co., Inc. (1888-91) In answer to a query asking what real value Kelly & Morey could have to Boettcher, FMR replied (McEwan) that Kelly & Morey have only a small processing operation in Denver and have personnel and salesmen scattered in small cities and communities, implying that these employees possibly supply Boettcher & Co. with municipal financing information from diverse locations (1889).

Similarly, Boettcher & Co. sent checks to three different firms in Seattle, Washington (1898). It also gave up to foreign dealers in Milan, Hamburg, Madrid, Beirut, Nassau, Rockingham, Nova Scotia and Hong Kong, none of whom had yet performed any service for Boettcher but who "might" be useful since Boettcher was "seriously considering opening a foreign office"(1913). Moreover, while some dealers did not respond with municipal information, Boettcher & Co. did not refuse to send give-ups to them nor did FMR suggest to them officially ["In talking to a few of them" FMR "might have mentioned ... that they should try to cooperate."] that they should relay information to Boettcher & Co. (1883, 1893, 1895). Thus Boettcher & Co. was paying out give-ups at FMR's direction to firms who as far as FMR knew, were not giving Boettcher & Co. municipal bond information (1895). Finally, it was clear that Boettcher & Co. would never have paid this amount for the information service if the money were from their own pocket (1919).

On July 12, 1968 FMR received a letter from Boettcher & Co. which informed FMR that the arrangement had been somewhat altered, stating in pertinent part:

"Late in 1966 it came to our attention for the first time that over-the-counter give-ups were not objected to by the New York Stock Exchange. Some of the dealers you were listing were being designated give-up commissions which were larger than could be justified for the municipal information or the research programs. Therefore, in some of these instances, we paid your designated give-up to the non-member NASD dealer via a give-up on our OTC trading. The over-the-counter transactions from which we "gave-up" were in no instance with any of the Fidelity Funds or with any Fund nor were they from transactions with our retail clientele, but only from over-the-counter transactions we had with other dealers. We limited the amount given-up on such transactions to one-half of the NYSE commission. You pointed out on the telephone this morning that we did not tell you about this OTC practice and you are correct." [Exhibit 204, at 3]

An arrangement was instituted in 1967 between FMR and Maxwell Ohlman & Co., a firm that could supply FMR with the names of broker-dealer members of the NYSE "who would be able to in some way get the equivalent of give-up commissions to NASD members." Approximately $900,000 [Mr. Ohlman's figure, undisputed by FMR] was directed (given-up to the member firm by FMR during 1967 and the first half of 1968, with, presumably, the equivalent of 50% redirected (given up) to NASD dealers (1924, 1930, 1935). The money was routed through Maxwell Ohlman & Co. whose affiliate, Information and Research Service, would be billed by the NASD dealers "for sales assistance" (1934). The NASD dealer would inform FMR "if they didn't get their money," however, the officers of FMR evidently were not aware of the arrangement (1935) Other NASD dealers who sold the Fidelity group of funds would suggest broker-dealer members of the NYSE, not suggested by Maxwell Ohlman & Co., who could also direct give-ups (1938-1940). Mr. McEwan apparently assumed that the NASD dealers who would receive the give-ups were providing the NYSE member firms with research (1942-1943).

Recapture of Brokerage Commission

On September 23, 1966 SEC staff members broached to FMR the possibility of returning give-up commission dollars to FMR's wholly owned-subsidiary in order to reduce FMR's management fee in furtherance of FMR's fiduciary duty to its fund shareholders. Perhaps as a result of SEC interest Mr. McEwan approached Mr. Lawrence of Boettcher & Co. to determine whether there might be "some service which would justify giving up to Crosby" (1909). It was never explained to Mr. Lawrence that the money was to be returned to Crosby in its status as underwriter affiliated with FMR, and thus back into the funds.

Whether or not Mr. Lawrence understood this is not clear but he concluded that Crosby could not be included in his list to receive give-ups (1909-1912).

Questioning by the Commission staff elicited other instances in which FMR could possibly have funneled give-up dollars back to the funds. FMR could have formed an overseas affiliate to perform whatever functions or services Boettcher & Co. received from foreign dealers. This it did not consider (1914). When FMR had S. J. Lind, Inc. included in an underwriting as a compensation for fund sales, it could have designated Crosby to receive the selling commission (1947). Apparently FMR did consider this method but rationalized that the decision "to invest in an underwriting offering is made at such a late date that the underwriting group is already formed and therefore the opportunity to include ... [Crosby] does not arrive very often" (1950). FMR wrote to NASD on June 6, 1968, "specifically requesting information from them whether such an inclusion in the underwriting group ... with the purpose of having the commissions returned to reduce management fees of the fund managed by FMR would violate any of their rules of fair practice" (1948). The reply FMR received on July 12, 1968 gave "no definite answer" (Id.).

FMR has also sent letters to the Boston, Detroit, Midwest, Pacific, and Philadelphia-Baltimore-Washington Stock Exchanges inquiring whether certain methods of directly or indirectly returning commission dollars to the funds would violate exchange anti-rebate rules. As of July 25, 1968, Boston had not replied and Detroit has simply acknowledged the inquiry (Fidelity Exhibit #1). The Midwest Stock Exchange stated that no give-ups could be directed to Crosby, a non-member of the Midwest, without violating Exchange rules and that an application for membership by a new subsidiary of FMR would probably not overcome the legal barriers (Id.). The PBW Exchange answered that commission dollars could be directed to Crosby consonant with Exchange rules, contrary to the statement on behalf of FMR that PBW's "reply to Fidelity's letter throws considerable question as to whether this avenue of recapture is now available" (Id.). The Pacific Coast Exchange replied that Crosby would probably not be eligible for full membership; PCSE did, however, grant Crosby's application for Preferred Rates of Commission, effective July 25, 1968 which allows member firms to direct 25% of a commission to Crosby and does not bar utilization of these dollars by Crosby to adjust the management fee (Commission Exhibit #256).

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APPENDIX

The following chart (see pp. 1864, 1865 of the record) demonstrates the percentage of the Fidelity group shares sold by members of various exchanges:

New York
1967 -- 60%
1st 5 months of 1968 -- 58%

Regional Only
1967 -- 6%
1st 5 months of 1968 -- 5%

National Association of Securities Dealers only
1967 -- 28%
1st 5 months of 1968 -- 23%

Foreign dealers only
1967 -- 6%
1st 5 months of 1968 -- 14%

The next chart demonstrates the proportion of portfolio brokerage of the Fidelity group of funds executed on the several stock exchanges for the first six months of 1968.

New York: 78.7%

American: 0.0%

Philadelphia-Baltimore-Washington: 1.2%

Midwest: 0.4%

Detroit: 0.6%

Boston: 2.8%

Pacific Coast: 3.0%

Over-the-counter Including third market: 13.3%

KEYSTONE CUSTODIAN FUNDS, INC.
July 23, 1968 -- pp. 1965-2051

Background

Keystone Custodian Funds, Inc. (Keystone) manages nine funds as trustee under separate but identical agreements of trust. In addition to the nine funds, Keystone also owns and operates a life insurance company called "Keystone Product Life Insurance Company." The four largest funds and their assets are

S-4 Fund -- $556,816,000
S-3 -- $199,149,000
S-2 -- $147,746,000

K-2 -- $330,265,000.

Keystone also manages several bond funds in addition to equity funds. The four funds set out above contained approximately 72% of the assets managed by Keystone in 1968. Keystone is a publicly-owned company with 25,000 shareholders. Its shares are traded over-the-counter. The principal underwriter of the funds is the Keystone Company of Boston, a wholly-owned subsidiary of Keystone. Since the funds are trusts, they do not have officers or directors. The corporate trustee of the nine funds is Keystone (1970). This is the only complex where the management fee is pro-rated on the total assets of the complex rather by individual funds. So shareholders of the smaller funds pay no more advisory fee per dollar than shareholders in the largest fund (1975). and the incentive for the underwriter-manager to sell one fund rather than another is essentially removed.

Sales

Beginning on page 1981 the witness described a method and amounts by which the fund intends to reciprocate for sales. They divide the producing dealers into three categories (1) "those whose sales are on an annual basis between a quarter and a half of million dollars annually"; (2) "sales dealers whose sales are between a half of million dollars and one million dollars annually"; (3) "those whose sales are in access of $1 million." These three groups represent about 10% to 12% of the number of dealers who sell Keystone Fund shares but who sell 80% of the shares sold. For group (1), the smallest of the three groups, the objective is to reciprocate 1 to 1-1/2% of sales, for group (2), 2 to 2-1/2%, for group (3) and 3 to 3-1/2%. The witnesses stated the rationale for this, "[o]ur generosity in this area should increase with the importance of the customer to us based on his production" (1982).

The largest sellers of Keystone's series K-2 fund include Dempsey Tegler, Offring and Ernst (an over-the-counter firm in Worcester, Mass.), Diversified Investment Services. DIS is a small selling organization, half-owned by Keystone and operating in the providences of Quebec and Ontario in Canada. It sells primarily Keystone products although about 5% of its sales are for other funds. Other larger sellers include Equity Securities, International Securities (based in Madrid), Westamerica Corporation (PCSE member), Bache, Securities Management Company, Ltd. (a foreign dealer based in Geneva). First Washington Co., and Main Street Management. Similar lists are indicated for 1966 but also includes H. O. Peet, Kelley Moray, Charles Marlin, Paine Webber.

Techniques of Execution

On 1991 it is explained why the fund has not been doing more business on the regional stock exchanges. The explanation was that the block positioning firms with which it primarily deals, prefer a New York tape print and also prefer that the specialist participates with them in a major portion of the block. It appears that block positioners prefer to have the specialist at risk along with them. For the Keystone Funds a typical order is closer to 10,000 shares rather than 400-500 shares (1991). The witness testified that Keystone is using block positioning firms today more and more because the auction market cannot absorb many of their orders. They have found this trend increasing in recent years. They choose their brokers depending on the difficulty and the size of the order. They have specialists who have demonstrated their abilities in these areas (1993). For example, in 1966 and 1967, Merrill Lynch was very active as a lead broker for Keystone but they have not been so active in 1968. The reason Merrill Lynch was used was because its service in executing block transactions on an Exchange-distributed basis through its wide-based branch office distribution (1978). Keystone was using Merrill Lynch basically for substantial orders which could not be absorbed in the regular auction market.

The reciprocal ratio does not vary with the broker's expenses (for example, if he has to pay a floor broker), the N1-R reports show that Keystone persistently used such firms as Bear, Stearns; Goldman Sachs; Donaldson; Dominick; Salomon Bros.; and Merrill Lynch. The witness said that these firms are used because of their block positioning abilities and that they are not requested to give-up on the part of the trade that they block position (1985) because they are at risk -- they are holding part of the block in their own account. The witness acknowledged that the use of firms like these limit Keystone's ability to distribute give-ups to other people who sell fund shares. Keystone has never asked third marketers to give up on their dealer trades.

<u>Allocation of Brokerage Reciprocal</u>

The top-ten firms that receive brokerage commissions from Keystone are shown in the record on page 1971. With the exception of Boettcher & Company and Equity Securities, the amounts listed are for direct executions (1972). The witness also identified Dempsey Tegler, a major lead broker for the funds, as having received substantial amounts through r give-ups as well as through direct execution. Dempsey does not give-up at the direction of Keystone; it receives both direct execution and give-ups because it is "a large seller of our fund shares" (1977); in 1968, it was the largest (1977). In 1966, Equity Securities was fourth in brokerage commissions received from Keystone, seventh in 1967, and much lower in 1968. The reason is that Equity Securities established its own fund, and as a consequence, its sales of Keystone Fund shares has dropped off.

In the allocation of direct commission business or give-ups, Keystone's funds are treated as one fungible complex in terms of sales of the funds' shares. In 1966, the percentage of brokerage done on each exchange for S-4, the largest fund, was as follows (1980):

New York: 77.6%
Amex: 4.5%
PCSE: 1.9%
Midwest: 1.8%
Detroit: 1.0%
Boston: 0.2%
PBW: 0.8%
OTC: 12.2%

Keystone estimates that these figures have not changed substantially as of July 1968. With the exemption of Dempsey Tegler and Bache, those who receive fund business for direct executions generally do not have relationship to the broker-dealers who sell the fund shares. Ninety-three percent of Keystone's transactions on stock exchanges were done on the NYSE and on the Amex. Nevertheless, the testimony shows that Keystone was still able to distribute give-ups to various classes of non-member dealers for fund sales.

Give-up Methods

The general give-up ratio for lead brokers is sixty percent. The witness testified that they can get effective quality executions by asking the broker to give up 60%. They use the complete 60% to motivate the sale of fund shares, and this is distributed to NYSE members and others. Some of the people to whom they are distributed are conduits who pass brokerage on to still other firms, such as the Stifel arrangement which Keystone uses.

Keystone first learned of the Stifel arrangement in 1965 when Stifel-Nicolaus & Co. came to them and "in effect said; if you can direct New York give-up business to us, we can be helpful to you in getting unrelated over-the-counter commissions to NASD members who are distributors of your fund shares." In January 1968, Stifel advised that they were not going to do this business anymore. In April 1968 they advised they would resume doing this type of business. The general ratio was for each dollar of New York commission business Stifel would give-up an unrelated over-the-counter commissions 50%, that percentage was now changed to 60% (1966). In the year 1967 they directed to Stifel Nicolaus $260,000, of which Stifel gave up $156,000 and retained $104,000. Out of an original dollar of brokerage the executing broker kept 40%, Stifel kept 24%, and the NASD member kept 36%. They allocated the brokerage of their IBM runs to their sales give-up program (1997). The witness testified that

Stifel volunteered to Keystone that they had developed this arrangement and checked it with the NYSE and told that it was not a violation of their rules. They were not familiar with the details of how this was done. When the Commission's 10b-10 proposal and a bulletin from the NYSE entitled Commission Rate Structure came out around January 2, 1968, Stifel stopped this arrangement til [sic] April of that year. At that time, Stifel said that they had received approval of their procedures both from the Exchange and the SEC and were willing to resume their give-up activities. Keystone resumed with them at that time. Although in October of last year Keystone testified privately on the matter they did not mention this to Stifel. The fund had no recollection of Stifel indicating they could possibly get the dollars back to the funds through this technique.

In July 1965 they started a similar arrangement with H. O. Peet (2003). In 1967 Keystone directed to Peet $174,000 of which they retained $70,000 and gave up $104,000. There was no interruption in the Peet arrangement during the time the Stifel arrangement was interrupted in the Peet arrangement during the time the Stifel arrangement was interrupted. Stifel and Peet were not executing orders but were merely conduits in the give-up arrangement.

Keystone began a similar arrangement with Boettcher in May 1966. Keystone had been told by Boettcher that their deal was slightly different, that "their technique has been to pay for advice given in connection with possible municipal bond financing." (2006-2007) Purportedly, Boettcher was paying the brokerage received from Keystone transactions to small NASD dealers who would in turn give them information about municipal bond financing. The record, either for this witness or for Fidelity Management, shows no indication that this was ever done nor that the arrangement differed from the Stifel arrangement. In 1967 they directed to Boettcher $240,000 of which they retained $96,000 and gave up $144,000. Keystone indicates throughout they were not very concerned with the details of the transaction. At page 2,010, witness Johnson said "I think we did not inquire in great detail. I don't think we were perhaps greatly concerned. We were assured by them [Boettcher] the arrangements, whatever they were, were perfectly valid and appropriate and we do not go behind what they told us." Keystone found that this arrangement was equally satisfying to the Stifel arrangement. Throughout they had about 40 or 50 firms designated to Boettcher. On several different occasions they directed Boettcher to send dollars to foreign broker-dealers. Boettcher never advised them as to the rationale as to why they could send money to foreign dealers. Three different types of letters were introduced into the record, at p.p. 2017 through 2019, which Boettcher apparently used as cover letters, to cover their activities so that it would appear on the record that they were generally using the information for some sort of municipal bond financing.

Douglas Securities, is a NYSE member who was suggested by Offering and Ernst. The latter came to them and asked them to establish this type of relationship. They then directed $100,000 to Douglas at which Douglas kept $40,000 and distributed $60,000 to Offering and Ernst. On pp. 2021-2022 the witness described give-up bookkeeping and the controls which they and their account exercised to attempt to make sure that the give-ups were actually received.

Associated Investors is a broker-dealer which distributes for Keystone in both the United States and Europe. Although it is not a member of the NYSE, it has apparently benefited from give-ups Equity has directed to it through executing NYSE members such as Oppenheimer, Coleman, Donaldson, Hertz, Neumark and Pershing (2025-2029).

Keystone explained how it directs give-ups to Equity Securities, a dealer-distributor which is not a member of any exchange: "As a non-member of any exchange, it has said to us historically over the years, 'If you will do New York business with firms A, B, or C', and they give us the names, 'we will be grateful to you!" "What they benefit or how they benefit, they have never told us, and we don't really -- any of us -- have any idea." (2030). Keystone directs between $300,000 and $400,000 per year either by check or by commission business to firms designated by Equity (see list of firms, p. 2031). Keystone asserted that it had no idea of how much of this amount is received by Equity; for purposes of internal record-keeping, it assumes Equity gets 50% (2029-2032).

After a trip to New York, International Securities Corporation, a foreign dealer of Keystone shares, came to them and said they had discovered a method by which they could benefit if Keystone would give New York business to particular firms. These New York firms included Dishy Easton & Company, Maxwell Ohlman. Money directed to these two dealers came from the firm Goldman Sachs, Oppenheimer and Hertz Neumark. Dishy Easton used trades on the Amex which were unrelated to Keystone trades in order to get money out (2036). The arrangement with Ohlman was that they would give money to such firms as Becker, Solomon, Carter Berlin, Bear Sterns, Dominick & Dominick, Glore Forgan, Hearney, Percell, Goldman, etc. and they would some how get it to Maxwell Ohlman, a member of the PBW. On page 2041 it appears those last listed brokers actually gave give-up checks to Becker who somehow got it to Ohlman through International Securities; they don't know how although they know Ohlman's split was 50-50. It was brought out that Mr. Rotberg had suggested to Keystone last November (and also in 1965) that Keystone could return give-up dollars to shareholders by naming the fund's underwriter, an NASD member, to receive give-ups. The suggestion was the subject of "general discussion at the executive level of Keystone," but was never acted upon or even discussed with outside counsel (2045-2050).

Exhibits

Exhibit #211 -- Introduced at Page 1968 is the statement of changes in net assets for Keystone Funds, Series K2, Series S2, Series S3 and Series S4 for the period 1965 through the ending of the latest fiscal year.

Exhibit #212 -- Introduced at Page 1975 is a description of the formula for the calculation of management fees and recurring charges applicable to all the Keystone Funds.

Exhibit #213 -- Described at Pages 986-989 lists the largest sellers of Keystone Fund shares, all funds combined, for the years ending December 31, 1966, December 31, 1967, and for the five months ending May 31, 1968. The exhibits lists the brokers by the amount (dollar) of shares sold and lists the dollar amount for each broker-dealer.

Exhibit #214 -- Entered at Page 1999 is the give-up account maintained by Keystone to account for the money paid to Stifel Nicolaus and the money which Stifel Nicolaus paid to others.

Exhibit #215 -- Introduced at Page 2000 is a letter from Stifel Nicolaus to Keystone Funds informing them that they will temporarily postpone their activities in the distribution reciprocal business to NASD dealers because of a bulletin from the NYSE, dated January 2, 1968.

Exhibit #216 is an internal memorandum of Keystone Funds dated April 26, 1968 describing a telephone conversation in which Stifel Nicolaus told Keystone that they would again distribute New York Stock Exchange brokerage to NASD dealers. They said that during the previous week they had received approval of their procedures from both the New York Stock Exchange and the SEC.

Exhibit #217 is a ledger account kept by Keystone to account for the brokerage distributed to and by H0 0. Peet. This exhibit is described on Page 2005.

Exhibit #218 -- Described at Pages 2007-2009 are samples of actual letters from the Keystone Company to Boettcher and Company from Boettcher and Co. to NASD recipients of give-ups of copies of IBM runs of Boettcher's over-the-counter transactions. One set of letters from Keystone to Boettcher lists the dollars that Boettcher will receive from other New York Stock Exchange members. Other letters from Keystone to Boettcher in this exhibit instruct Boettcher how much and to whom it should forward dollars. Other letters in this exhibit go from the NASD recipients of the give-ups back to Boettcher.

Exhibit #219 -- Described at Pages 2009-2011 -- This package of letters and materials are virtually the same as those in 218.

Exhibit #220 -- Described at Page 2011 is a recapitulation of payments made to NASD dealers by Boettcher and Company.

Exhibit #221 -- Described at Pages 2011-2013 -- They are substantially the same package of materials as has been described for the previous several exhibits.

Exhibit #222 -- Described at Pages 2014-2015 -- It is substantially the same as the last several previous exhibits.

Exhibit #223 -- Described at Pages 2016-2017 -- It is virtually the same as described before except in that the letters from Boettcher expose some of their cover-up as they mention that they will no longer be using the municipal bond business.

Exhibit #224 -- Described at Pages 2017-2019 are a series of three types of letters which Boettcher was sending to NASD recipients of give-ups. These also elude to the alleged municipal bond practice.

Exhibit #225 -- Described at Pages 2020-2021 and Pages 2023-2024 -- This is a ledger account for the give-up account for Douglas Securities in 1968. Douglas was running a similar operation to Stifel, Peet and Boettcher.

Exhibits #226 and 226a -- Described at Pages 2025-2029 are the give-up accounts of Associated Investors who was a foreign dealer who distributed Keystone Funds and according to the explanation also acted as a conduit to other NASD dealers and is still not altogether clear from this explanation as to why Associated Investors was being used as a conduit to other NASD dealers. It itself was getting money from a conduit.

Exhibit #227 -- Described on Page 2031-2032 is a ledger account in which the dollars distributed at the request of Equity Securities Corporation are accounted.

Exhibits #228 -- Described on Pages 2036-2041 are the ledger and control accounts in which the give-ups directed to International Securities Corp. through Dishy Easton and Co. and other brokers is shown.

Exhibit #229 -- Described on Page 2041 is the internal ledger account of Keystone Funds indicating the arrangement with Maxwell Ohlman and how those dollars were distributed.

Exhibit #230 -- Described on Page 2042 is a description of procedure for Hertz Neumark's give-up to International Securities Corporation.

Exhibit #231 is a series of letters which reflect the give-up transactions between Hertz Neumark, International Securities and other broker-dealers and the ledger reflecting the transactions. The description is on Pages 2042-2043.

Exhibit #232 -- Described on Pages 2044-2045 are ledger accounts reflecting give-up arrangements with Rasher Pierce and Company and Persmick, Frolick and Frost.

Exhibit #233 -- Described on Pages 2045 reflects the same type of arrangement with Dishy Easton and Company and Keystone.

TSAI MANAGEMENT & RESEARCH, INCORPORATED
July 24, 1968 -- pp. 2055-2127

Mr. Gerald Tsai, President of Tsai Management and Research, Inc. (TSAI). testified. TSAI is a registered broker-dealer, a member of the NASD, and a registered investment adviser managing five mutual funds. It has a subsidiary that provides investment counseling service. The five funds are: Manhattan Fund, Liberty Fund, Hemisphere Fund, Fundex, Inc., and TMR Appreciation Fund; all except Hemisphere Fund are open-end funds (Fundex is an open-end fund but is no longer selling shares) (2056). TSAI or its subsidiary are the underwriters for all its funds that are currently offering shares to the public. The funds are not associated with any particular broker-dealer. The subsidiary manages $80 million in private accounts.

The directors for all the funds are identical. There are three unaffiliated and two affiliated directors (2059). There is one fund trading department made up of two senior traders and a clerk that is paid for by the management company and is not a compensable expense.

The advisory fee for particular funds varies. Manhattan Fund, formed in December 1965 and which had assets of about $500 million on June 30, 1968, is the largest fund. (Assets of the other funds total somewhat less than $60 million [2062].) It pays an advisory fee of 0.5% of the first $250 million in assets, 0.475% of the next $250 million, and 0.45% of the next $250 million. It paid a management fee of $2,583,431 to TSAI in 1967, and paid gross commissions of $6.8 million in 1966, $6.4 million in 1967, and $2.5 million in the first half of 1968.

Under its contract as underwriter, TSAI also receives 2% of gross sales of Manhattan Fund shares.

Most of the Manhattan Fund trades are blocks of 1,200 to 1,500 shares. In January, 1968, there were 20 trades in excess of 10,000 shares amounting to 10% or 12% of the total trading volume (2066).

Approximately 70% of TSAI's business is done on the New York Stock Exchange, 10% on the Amex, 10% on the regional exchanges, 8% on the third market, and 2% over-the-counter (2066). Its trading department has wires to 37 member firms primary brokers: 75% of the trades are executed by these firms (the top executing brokers in terms of commission dollars are listed on pages 2069 to 2071).

The primary brokers that TSAI uses for execution are asked to allocate part of their commissions to other securities firms for research services or sales services (2072). The term "sales services" means selling shares of the funds which TSAI manages. The retention rates of the primary brokers vary between 43.9% to 62.2% (2073).

At times TSAI is able to direct a give-up on block positioned trades. It contacts an NYSE member, Bear Stearns, for example, and asks it to bid on the block. Bear, Stearns checks with the stock's specialist to see if he will take part of the block; at the same time it tries to locate an institutional buyer. If the block is placed between such a buyer and the specialist, TSAI expects Bear, Stearns to give-up more. If Bear, Stearns has to take up the whole block thus bearing a greater financial risk, TSAI would ask for a smaller give-up -- probably 50% (2074-2075). TSAI did testify that many times he is able to direct a give-up when the entire block has been positioned by the broker. TSAI was asked whether it negotiated for give-ups in connection with each separate block, and/or whether it had a general understanding with the block positioner. Mr. Tsai replied, "on this type of situation it is on-the-spot negotiation. I do it personally. Most of the times, we have a standard give-up ratio" (2075). As a general rule, the primary brokers are asked to allocate (give-up) 60% and retain 40%. All of the top ten confirming brokers show more than 40% retained, but TSAI explained that it also gets research services from these firms.

Manhattan Fund has sales agreements with about 3,000 dealers, however, only 700 or 800 sell primarily Manhattan Fund shares. The third and fourth largest sellers of fund shares are located outside the United States (2082). In 1966, 81.97% of Manhattan Fund shares were sold by NYSE members, 3.3% by regional-only members, 9.84% by NASD dealers, and 4.86% by foreign dealers. In 1967, it was 65.4% by NYSE members, 3% by regionals, 9.12% by NASD members, and 22.48% by foreign members.

TSAI gives-up to the sellers of its funds' shares as a reward for past sales efforts or to encourage future sales efforts. Generally it returns 2% of the sellers total sales. For a special sales campaign, it may be as high as 4%, but never more (2096). The original offering of Manhattan Fund in early 1966 was a little over a quarter of a billion dollars. The Fund is currently up-to-date in paying give-ups for sales and does not owe any dollars for past sales.

TSAI is able to direct NYSE brokerage back to NASD-only dealers through unrelated trades on regionals. TSAI has never specifically asked a primary broker to execute on a regional exchange to enable TSAI to direct give-ups to NASD dealers. It does occasionally ask them to make brokerage available on regional exchanges to NASD dealers on unrelated trades (2092). The orders that are executed on regional exchanges are primarily crosses where the primary broker has located the other side. TSAI says it makes no difference as to the price of the trade where those orders are executed (2093).

In early 1966, Stifel, Nicolaus (SN). an NYSE member, told TSAI that it had an arrangement whereby TSAI could distribute dollars to- NASD-only members. TSAI began using the method in the middle of 1966 (2101). At TSAI's instruction NYSE member firms would send a give-up check to SN. TSAI would direct SN to pay 60% of that give-up to an NASD-only member for sales services that the NASD-only member had performed for Manhattan Funds. SN retained 40% of the dollars given up to them and sent 60% to NASD members. SN represented to TSAI that the arrangement had been approved by the Securities and Exchange Commission, the NASD and the NYSE. In December, 1967, TSAI learned that the Commission had begun questioning that arrangement, and TSAI terminated its use. Up until that time, TSAI had directed approximately $225,000 to SN (2102).

TSAI compensates foreign dealers through the courtesy device. To reward foreign dealers, TSAI occasionally gives business to New York Stock Exchange members designated by foreign dealers or "through the courtesy of a foreign dealer." One of the principal NYSE members so designated is First Hanover Corporation. TSAI does not know what arrangements First Hanover has with the foreign dealers involved. In the first half of 1968, First Hanover received $75,000 in both direct and allocated commissions (2100).

In the past TSAI has compensated IDS through Arthur Lipper & Co. (Lipper). For instance, IOS was compensated by TSAI's allocating commission business to Lipper at IOS's request (2084). Lipper does not sell Manhattan Fund Shares (2088) and TSAI is not aware of any specific arrangement between IOS and Lipper. In 1967, Lipper received $25,000 for sales, and $1,600 for research, but received a total of $54,382. [Footnote: The record contains no explanation for the missing amount.] Lipper is one of TSAI's primary brokers and block positions for TSAI (2086). For the first six months of 1967, Lipper received gross commissions of $53,852 from TSAI, and, as in 1967, retained the full amount. This was direct commission business, not give-ups (2087).

In February of this year, TSAI approached Reynolds & Co. with a plan to reward NASD dealers. At that time, TSAI had two wholly-owned subsidiaries, TMR, Inc. and TMR Appreciation Fund, which invest TSAI's own money in securities. [Footnote: TMR Appreciation Fund has subsequently been offered to the public.] TSAI directed commission dollars from these transactions to Reynolds in return for Reynolds using its regional business to compensate NASD dealers in connection with Liberty Fund sales. (Liberty Fund is an income fund which TSAI runs and which does not pay its own way.) TSAI wanted to build up Liberty Fund so that Manhattan Fund holders would have an income fund to switch to if they so desired. Mr. Tsai said that the dollars given to Reynolds were TSAI's dollars and not any of the Funds' commission dollars.

On two occasions, TSAI has requested distribution of solicitation fees received in connection with tender offers. In one case where Manhattan Fund owned the security, the soliciting firm was requested to give-up a portion of the solicitation fee to TSAI. Apparently TSAI later returned the money to Manhattan Fund (2109). On a second occasion, none of TSAI's funds owned the stock. TSAI gave Rothschild, the broker, a list of broker-dealers to whom to distribute Rothschild's solicitation fee. In return, TSAI gave Rothschild $25,000 in New York Stock Exchange commission business (2109).

When distributing brokerage, TSAI looks at the funds as a package, and therefore it is occasionally possible that Manhattan Fund's commission dollars are used to pay for Liberty Fund's shares. This also applies to research which might flow both ways (i.e., information given to Manhattan Fund being used for Liberty sales and vice versa). TSAI definitely did use Manhattan Fund brokerage at one point to pay off on Liberty Fund sales, although this arrangement started with TMR, Inc., one of the subsidiaries (2108).

Even though TSAI is a registered broker-dealer and a member of the NASD, it has never asked a primary broker to direct commission dollars to TSAI in connection with his unrelated regional stock exchange business. It has never requested that the tender fees from a solicitation of a stock which TSAI does not own be returned to TSAI, although TSAI is an eligible recipient as a member of the NASD. TSAI believes that it would have been an eligible recipient under the SN arrangement, but it has never discussed with counsel whether it would be an eligible recipient on regional stock exchanges.

In two instances, TSAI has had dealings with Maxwell Ohlman & Co.; in neither case was Manhattan Fund business involved. TSAI paid brokerage to Maxwell Ohlman from TMR, Inc. and TMR Appreciation Fund. At that time these were wholly-owned subsidiaries of TSAI, so it was TSAI's dollars that were paid. Once TSAI paid $1500 to a free lance writer in connection with the preparation of the Manhattan Fund's Annual Report; another time it paid $17,000 of overtime for a Manhattan Fund Annual Report printing bill. These payments were made out of TSAI's own commissions, so they reduced the expenses of Manhattan Fund. TSAI could also have legitimately used commission dollars of Manhattan Fund to compensate Maxwell Ohlman for the services which Maxwell Ohlman provided the Fund (2112).

In 1967, TSAI gave up over $1 million for research and over $1 1/2 million for sales. TSAI indicates that it would be very upset if give-ups were abolished; that without give-ups a manager could not afford to pay for research unless either the management fee was raised or the fund shareholders were billed directly for research (2117). However, TSAI believes the latter would be impractical since TSAI has the commission dollars and cannot see why it should not be able to continue to use them. TSAI said that it could not afford to pay for research directly because the advisory fee is too low; it predicted that the quality of research would suffer if give-ups were abolished.

PHILADELPHIA-BALTIMORE-WASHINGTON STOCK EXCHANGE
July 24, 1968 -- pp. 2128-2181

Mr. Elkins Wetherill, who testified, is the President of the Philadelphia-Baltimore-Washington Stock Exchange. In May, 1965, he became chief officer of the Exchange, which is a consolidation of the Baltimore Stock Exchange, the old Washington Stock Exchange and the Philadelphia Stock Exchange.

The PBW has 162 member firms, of which 68 are members of the NYSE. The Board of Governors has 24 members; 14 of these are affiliated with the NYSE (2129-2130). Although approximately 700 securities are listed on the PBW, over 95% of the volume of trading is in securities which are also listed on the NYSE. Some of PBW's specialists are also members of the NYSE. In 1967, the volume was 38,454,000; in 1968, the average has been about 200,000 shares per day (2131).

The minimum commission schedule on the PBW is identical to the NYSE's. On the PBW the specialist is also the odd-lot dealer and he deals at the same differentials as on the NYSE (2132). The Exchange membership prior to January, 1967 contained such financial institutions as Gerstley, Sunstein; Drexel, Harriman; and Lehman Brothers, all of which are investment advisors to the funds (2132-2133).

PBW has been trying to increase floor volume by finding new sources of business. In late 1965 or early 1966, the constitution was amended to allow foreign membership, and new members were actively solicited in Montreal. Four Montreal firms Lafferty, Harwood & Co; Brodique & Chapeau; Morgan, Ostiguy & Hudon; and Oswald Dunkwater & Graham joined the PBW (2135). The PBW extended its campaign to Europe and added Credit Lyonnais Corp., which is affiliated with Credit Lyonnais Bank, a French Bank and a manager of mutual funds (a substantial amount of the stock of the French parent is owned by the French government.) Suez American, a subsidiary of Compagnie Financiere de Suez et de L'Union, a publicly owned holding company which also manages mutual funds, and Bear Securities, a subsidiary of Julius Baer, a privately owned Swiss Bank (2136-2138). The PBW considers these additions "a success story" because of the increasingly heavy use made by these firms of the Exchange. In April, Credit Lyonnais executed 10,750 shares on the PBW, 18,900 shares OTC and 8,500 shares on the NYSE; in June, the figures were 32,125 on the PBW, 6,700 OTC, and 1,000 on the NYSE (2140). In order to go over-the-counter in securities listed on the Exchange, the firm would first have to try the floor and get a release. Most of the transactions were 100 to 500 share orders; it is not known whose orders they were. Presumably, the mutual funds in these complexes execute portfolio transactions through the foreign PBW member (2142). The rules of the Exchange do not restrict the securities transactions of the parents in any way. (If the French government, any of the PBW-member-controlled mutual funds or the holding company want to execute through their own members the PBW would have no objection.)

PBW continued its expansion program by encouraging domestic corporations to form affiliates which would become PBW members. A holding company, for example, could form a member affiliate, or a member could expand by forming an affiliate to go into other areas of the securities business (2145).

Porteous & Co. is a member firm admitted in August, 1966. Porteous sells shares of Pennsylvania Funds (a mutual fund). and also owns the management company of Pennsylvania Funds, Provident Management Co. Porteous owns the management company, the brokerage firm and the selling group. The rules of the PBW do not prohibit him from reducing his advisory fee by the amount of commission he receives (2146).

Cannon & Co., a member firm is owned by the same individuals who own all the shares of P.R.O., Inc., an agent for life insurance companies. P.R.O., Inc. owns voting control of P.R.O. Services, Inc. which is the principal underwriter and investment advisor to P.R.O. Fund, Inc. P.R.O. Services is also a broker-dealer and a member of the NASD; it sells life insurance as well as securities (2149-2150). Portfolio orders of the Fund can be executed by Cannon under the rules of the PBW (2150). Also Cannon can declare a dividend which would go back to the management company (2151).

Republic Securities Corp. is a member firm and a subsidiary of Steadman Security Corp., underwriter and investment advisor of the Steadman Funds (2151). SSC is a registered broker-dealer and member of the NASD. The funds managed by Steadman can use Republic to execute orders. The PBW has no rules that prevent the profit from the member flowing back to the fund through a reduction in the investment advisory fee (2152).

The PBW has no rules which prohibit a registered broker dealer which is a member of the NASD whose parent is publicly owned from becoming a member; nor is there a prohibition if the broker-dealer has a subsidiary or affiliate which is publicly owned (2153). IDSS could join as could a subsidiary of Fidelity if they could meet existing exchange rules pertaining to qualified personnel and back office requirements (2157). The PBW has no power to tell the NASD member what it can do with its commission or give-ups and has previously advised Fidelity that it was not Exchange policy to prevent NASD members, receiving give-ups at the direction of an investment company, from crediting such give-ups against the management fee.

Mr. Thompson, who is associated with Winn Dixie Stores and who is also a financial adviser and manager of an estate, formed St. John Securities, Inc. and acquired membership on the PBW. He did this to go into a public broker-dealer business but also to save commissions for the estate he managed by executing as many of his own orders as possible (2161-2162).

INA, likewise, formed a subsidiary and sought and acquired membership. Membership was acquired, however, only after heated debate within the Exchange as some members objected to customers becoming competitors (2165). INA informed the PBW that it did not intend to execute any portfolio transactions of the insurance company, but the PBW did not request this statement and nothing in the rules prevents such executions (2166-2168). PBW feels that there is no reason why the NYSE could not have this arrangement but "it is easier for" the PBW to experiment (2169).

The PBW is continuing its pursuit of foreign banks as a source of strengthening its market (2172). Article XIV § 3 of the Constitution bars banks from becoming members but has been interpreted to not exclude foreign banks in their capacity as a broker-dealer (2174) -- The Exchange felt that this rule was adopted as a result of the Glass-Stegall Act. The Exchange very strenuously emphasized that currently any prohibition on membership is subject to change and that upon getting an application from anyone, including a domestic bank, they would be willing to review their stand.

In testifying on PBW's position as to whether a mutual fund manager or underwriter who is a member of the NASD could get give-ups back to the broker-dealer on PBW, the witness said that they have no control over what happens to the give-up. He disagreed with Fidelity Management's testimony that a letter from the PBW to Fidelity "throws considerable question as to whether this avenue of recapture is now available" (2156). There is no reason, and PBW's letter indicated no reason, why they could not recapture the brokerage.

Exhibits

No. 240 -- List of PBW Affiliates

No. 241 -- PBW letter to Fidelity (Very Important)

No. 242 -- INA letter to PBW

No. 243 & 244 -- Memo and Cover Letter -- Memo prepared by Philadelphia National Bank encouraging foreign banks to join PBW and use Philadelphia National Bank for Paperwork

No. 245 A & B -- Letters referring to Above Memo

No. 246 -- Reserved Exhibit -- Legal Memo of Glass Stegall Act

No. 247 -- Reserved Exhibit -- Prospectuses of P.R.O. Fund, Steadman Fund and Pa. Fund

INA CORPORATION
July 25. 1968 -- pp. 2182-2225

INA Corp. is a holding company formed in early 1968. Through an exchange of stock it became the parent of Insurance Company of North America (INA). INA Corp. is listed on the PBW and NYSE (2185). INA engages in all lines of the insurance business except life insurance, which is conducted by its subsidiary, Life Insurance Company of North America (2186). INA Corp. owns over 90% of INA. INA's total assets are approximately $1.5 billion and of that amount about

$800 million is in equity stocks (2187). Mr. John Penland was the firm's major spokesman.

INA Trading Corp. is a registered broker-dealer firm. It is a member of the NASD and the PBW. INA Trading Corp. was formed on May 2, 1968 and became a member of the PBW in June 1968 (2187-2188). The seat cost $30,000 and John Penland is the individual member (2188). The Trading Corp. is a subsidiary of Philadelphia Investment Company which is a wholly owned subsidiary of INA (2188).

INA Securities Corp., also a wholly owned subsidiary of Philadelphia Investment Company, is a registered broker-dealer and a member of the NASD. This firm is licensed in 45 states and is a retailer for 18 funds. The firm has selling agreements with the Delaware Management Company, The Crosby Corp., Dreyfus Corp., Wellington Management Co., and American Funds Distributors (2189). The Security Corp. has trained and tested about 1500 salesmen, and has received test results from the NASD for about 600 of these persons (2190).

The stock of the Trading Corp. is held pursuant to a voting trust which was entered into to satisfy the rules of the PBW requiring that the operating officers have absolute control over the member broker-dealer (2191) o

Trading Corp. will engage in a general brokerage business. It will have its own sales force but probably will not have a partner on the floor, using instead another broker as a $2 broker (2192). The firm will do OTC and listed business (2193).

One of the reasons the INA complex was interested in exchange membership was to establish a recipient for give-ups directed by funds whose shares were being sold by the Security Corp. (2195). This arrangement would arise where a fund executes a portfolio transaction on the PBW and directs a give-up to the Trading Corp., or where a fund executes on the NYSE and directs reciprocal business to the PBW in order to give-up to the Trading Corp. (2196). This give-up would reward INA Security Corp. for its sales efforts or INA Trading Corp, for research or other services. The Trading Corp. may have its own floor broker (2197 and 2192). INA feels that it should be able to gross about $1 million of fund shares sold (2197).

A second reason for interest in membership was that if the funds cannot or will not direct give-ups, INA Trading Corp. could actually execute transactions and receive the entire commission less expenses (2197). The third reason for membership was to facilitate liquidating equity portfolios of Security Corp. customers who bought mutual funds (2199). The shareholders of INA Corp. will benefit from any profits that arise from the operation of a securities business (2200).

Trading Corp. first began to explore the possibility of membership in April 1968, and applied for membership on May 8, 1968. Trading Corp.'s membership will strengthen the PBW market by bringing referral business to it (2207). The PBW was chosen because it has a wide listing of securities and affords associate membership on the Montreal, Boston and Pittsburgh Stock Exchange (2207).

INA has no agreement that the securities of the INA portfolio will or will not be executed on the PBW through the Trading Corp. At present the INA commission business is allocated on the basis of services (such as research) rendered by brokers to INA (2208-2209). INA has not been a major user of the give-up in allocating brokerage because its portfolio activity is relatively limited (2210).

The budgets for commission costs and research are determined twice each year; direct commission business is used to pay for research (2218-2219). For 1967, INA's budget allocated $500,000 for stock exchange commissions; this figure was less than $200,000 in the first six months of 1968 (2212). Actual stock exchange commissions from investment activity on portfolios managed by INA totaled $251,000 in 1967 and $84,000 for the first 6 months of 1968. NYSE business accounted for $237,800 in 1967 and $80,000 for the first half of 1968 (2213).

INA directed $6,089.00 in give-ups in 1967 and $11,000 from January 1 to June 30, 1968. All 1967 give-ups were directed to Boettcher. In 1968, give-ups were directed to Boettcher, H. D. Wainwright, Mittendorf-Colgate, Butcher & Shererd, and Grayson & Co. These give-ups were directed primarily for research (2214). INA has no reciprocal business that is allocated (2215). INA's research people determine the placement of limit orders. For that reason, the competence of the particular broker who executes the INA order is of little importance (2216-17). INA Securities Corp. has plans to underwrite a mutual fund that would be formed within INA. INA Trading Corp. will trade on the PBW as agent in shares of INA Corp. but not as principal (2221).

<u>Exhibits</u>

Exhibit #248 is a memorandum to the INA files giving reasons for INA's interest in exchange memberships. Exhibit #249 lists INA's commission and give-up business.

<u>PUTNAM MANAGEMENT CORPORATION</u>
<u>July 29, 1968 -- pp. 2228-2337</u>

INTRODUCTION

Putnam Management Company (Management) acts as investment advisor for the George Putnam Fund, Putnam Growth Fund, Putnam Investors, Inc., Putnam Income Fund, Inc., Putnam Equities Fund, Putnam Vista Fund and Putnam-Duo Fund. These funds, with total assets of $1.7 million (2233). make up the Putnam Group of Mutual Funds, and are registered under the Investment Company Act of 1940 (2229). Management does not act as adviser for any other fund and is not registered as an investment advisor with the S.E.C. (2230). In addition to research and portfolio management, Management also furnishes office space, equipment, bookkeeping, clerical and statistical service to the funds as well as the payment of compensation to all affiliated officers and directors (2234). Mr. George Putnam, President of Management, testified.

The advisory fees paid by the various Putnam funds are as follows:

George Putnam Fund -- 1/2 of 1% on the first $100 million of assets, 35/100's of 1% on the next $100 million of assets and 30/100's of 1% on everything over $200 million of assets.

Putnam Investors Fund -- 50/100's of 1% on the $50 million assets, 40/100's of 1% on the next $150 million and 34/100's of 1% on the excess of $300 million.

Growth Fund -- 50/100's of 1% on the first $150 million, 40/100's of 1% on the next $150 million and 34/100's of 1% on the excess of $300 million.

Putnam Income Fund -- Straight 6% on the gross annual investment income, not to exceed, 1% on the average monthly asset value of the fund in any one year (2332).

Since the first three funds are already over the maximum rate differential, an increase in the sales of these shares will no longer lead to a decrease in the advisory fees charged (2333).

There are two major underwriters for the funds mentioned: Putnam Funds Distributors, Inc., and Planned Investment Corporation, a Canadian firm in which no interest is owned by Management, which underwrites only Putnam Growth Fund (2230-2231). Mutual Fund Associates, Inc., a wholly-owned subsidiary, is a retail distributor of funds in the western part of the U.S., and has its sales force distributing other funds as well as Putnam Funds.

Generally, the same people are officers and directors of Putnam Fund Distributors, Mutual Fund Associates and Management. With respect to the Funds Group, the unaffiliated directors are the same for the four biggest funds while all of the affiliated directors are officers of the underwriting companies and Management (2232-2233).

There is one trading department composed of two full time equity traders and two full time bond traders serving all of the funds. Management bears the entire cost of the department as a direct expense and not as compensable expense (2236).

<u>EXECUTIONS</u>

Several of the complex funds may have overlapping investment objectives, the trading department will often purchase a single security for more than one fund. The stock is divided at the end of the day according to the size of the authorization from each fund. If the number of shares purchased is insufficient to satisfy all the authorizations, a committee determines the appropriate funds to receive the acquisitions. The same pro-rata formula used for sales (2236-8).

The approximate percentages of total transactions carried out by the funds on the individual stock exchange are:

New York: 78%

American: 2%

Boston: 4.5%

Detroit: 3.75%

P. B. W.: 3.75%

Pacific: 2.4%

Cincinnati: 0.3%

Midwest: 0.5%

Over-the-counter: 5%

The last figure includes third market transactions as well as the over-the-counter market for non-listed securities (2241-2).

Putnam stated that most of the business taken to the Boston and Detroit exchanges was pre-arranged crosses, but that he was not sure whether the same was true with respect to the Pacific Stock Exchange. These crosses are directed to the regional exchanges because of the particular give-up rules involved. The price at which the cross is executed is based on the New York auction market (2243-4).

For executions in the over-the-counter market of stocks not traded on national exchanges, Putnam pays "the typical negotiated commission" of one-eighth where the share if under $20, one-quarter between $20 and $100 per share and one-half over $100 shares. The witness was unable to say whether this amount of commission approximately equaled the amount retained by NYSE members after give-ups (2251).

GIVE-UP AND RECIPROCAL BUSINESS PRACTICES

A comparison was made between three types of lead brokers. First, those who do not sell fund shares and who are directed to give up from 50% to 75% of the commission paid by Putnam; second, two-dollar brokers who in effect give up 90% of their commissions since they only get 10% of the total amount paid; and third, brokers who, because they execute portfolio business and sell fund shares, keep 100% of the commissions. If all brokers were required to keep all of the commissions paid to them, Management would probably use a broker who sold fund shares, everything else remaining equal. Nevertheless, large institutional lead brokers would often have to be used since only they block position and render other services which the funds must have (2280-2282).

For transactions on the Boston Stock Exchange, the broker used is generally Cantella and Co. Limit orders to buy, for instance, based on the last sale of the NYSE, are given by Putnam to Cantella. Cantella has the order executed on the New York Stock Exchange for his own account by a NYSE member to whom he pays a full non-member commission rate. He then sells these shares to Putnam through the Boston Exchange. Putnam pays the full non-member commission and directs Cantella to give up 40% to NASD members and 10% to Boston Stock Exchange members (2244-6). The price of the stock is based on the New York auction market but this indirect method is used because the give-up rules on the Boston Exchange are more liberal. For the same reasons, the Detroit and PBW Exchanges are also used (2246).

One method used to execute orders on the NYSE is to give the order to J. C. Bradford, a member of the New York Stock Exchange and dealer in Putnam funds. The order is executed on the floor of the exchange by either Pearsall and Company, New York Securities, Williams D. Witter or Ungerleider, Goetz who are floor brokers. These brokers are in direct contact with the Putnam trading department. J. C. Bradford, who has nothing to do with the trade, sends the confirmation to Putnam and receives the full commission on the order. He then pays the floor brokers 10% of that commission. In reality, the brokers are giving up 90% to Bradford (2266-71).

Like Bradford, who also receives commissions in the form of give-ups from brokers doing portfolio business for the funds, Burgess and Leith, sellers of large quantities of Putnam shares, receive commissions through give-up checks and direct orders.

These orders, which comprise about 50% of Burgess and Leith's commission receipts from Putnam, are executed by their own floor brokers primarily at the NYSE (2271-2274).

Edwards and Hanly, NYSE members with their own broker on the floor, receive the majority of their reciprocal commission payments through direct orders by Putnam. Unlike Bradford, they retain 100% of the commission paid because they bill, clear and deliver the order (2275-7). But, it was admitted that Edwards and Hanly were not required to give-up any part of their commissions because they were selling Putnam fund shares and from 70% to 80% of those commission were allocated as compensation for those sales (2277).

Compared with NYSE member firms, NASD members cannot participate easily in reciprocal business agreements. It is relatively simple to allocate NYSE commissions to members, but a tremendous amount of business is needed to make an equal amount of dollars available to NASD members since NYSE members cannot give-up to non-members directly on trades executed on the NYSE. There has been greater pressure by the NASD in recent years to increase reciprocal business.

The amount of reciprocal business given is determined by the gross number of fund shares sold. No consideration is given to the shares which are redeemed over the year when computing the amount of reciprocal, although Management does account for redemption by each broker. Also, the same amount of reciprocal business will be given to two firms selling the same number of shares even though one firm has its own floor broker while the other must pay a full floor brokerage and clearance fee to carry out the funds' transactions. If the reciprocal business is a cross where the broker selling the fund shares will receive commission from both sides of the trade, there is no attempt on the part of Putnam to lower the commission it pays for its side of the cross (2259-2262).

A firm receiving reciprocal business in the form of an order incurs certain expenses through the execution of that order, while a firm receiving a give-up check incurs no expense. Nevertheless, Management's books simply show that both firms receive the same amount of reciprocal business. This was explained as being the only way the books could be kept accurately (2262-4).

In rewarding dealers who are not stock exchange members for the sale of Putnam Mutual fund shares, the industry practice is followed. Reciprocal business in the form of commission give-ups from portfolio transactions is directed to fund dealers. There is no attempt to require that the sale of a particular fund be rewarded only with the commissions paid out by the fund or to determine what proportion of each fund each dealer sold. In other words, Fund A may pay a commission to a broker for a portfolio transaction and direct that he give-up to a dealer who sold Fund B (2253). It is contended that this is beneficial to the fund shareholders for the following reasons: first, it is the industry practice and the only way to assure fund sales; and second, fund shareholders quite often hold more than one Putnam fund and the practice is beneficial to the entire group of funds. It was admitted that for a shareholder who only owns one fund there is no present benefit when commissions from his fund are used to reward the sale of another fund. But, the explanation that there is a good chance of that shareholder either changing to another or obtaining a second Putnam fund, thus eventually benefiting him, was reiterated (2254-7).

An arrangement between Putnam and Hertz, Warner, a NYSE member, supposedly at the suggestion of Hertz. provided a means of transferring give-up commissions to Kelly and Morey, a non-NYSE member selling Putnam fund shares. Commission would be paid to Hertz through direct orders and directed give-ups from other brokers. The amount of these commissions was based on a rate of 6% of the total sales of Putnam funds made by Kelly. Hertz would then provide Kelly with about one-half of those commissions. This amounted to about $28,000 for the first six months of 1968. Management neither knew or was interested in learning the method used by Hertz to carry out the arrangement. At the request of Hertz, the agreement was oral and no letters confirming the give-up or the amount paid were ever provided (2282-91). Similar arrangements existed with Pressman, Frolich (2294). First Hanover (2297). Haight and Company (2298) and Loeb, Rhoades (2298).

Though it was insisted that no NYSE commissions were being given to non-members, there was no attempt to identify or specify the origin of dollars given to NASD members and the only dollars involved in the transfer seemed to be NYSE commissions (2255). Generally, Management claimed it did not know how the dollars were transferred nor did it attempt to find out. Only in the case of Loeb, Rhoades was it suggested that unrelated trades in the form of crosses were being taken to the Boston Stock Exchange whereby 40% of the commission involved were being given-up to NASD members (2298-0).

In connection with the portfolio business of the individual funds, Management maintains direct telephone lines to many member firms, one of which is Hayden, Stone (2300). In return for give-ups and direct commission business, Hayden, Stone incurs the entire expense for the line. Though in reality the fund shareholders are paying for it, the premise is that the line benefits them by facilitating the trading of fund portfolio shares (2301). The source and amount of dollars provided for these lines were unclear, but it was evident that more commissions were being given than was revealed to cover the disclosed cost of the lines (2300-3).

Elaboration on the arrangements for transferring dollars to NASD members who were non-NYSE members disclosed that it was the policy of management not to have these dollars returned to its subsidiaries, Putnam Fund Distributors and Mutual Fund Associates, both NASD members. It was felt that such a policy might involve a violation of the anti-rebate rules, but there was a reluctance to discuss any specific rule or how it might apply to this situation. Management's main contention was that it was more advantageous to fund shareholders to make these dollars available as a reward to those who sell the fund shares. If there was a return to Management or its subsidiaries, it was believed that fund sales would decline. There was an express willingness to allow part of these dollars to "stick" to conduits such as Hertz, Neumark in order to insure this advantage (2305-16).

Even though certain firms such as Investors Planning Corp. and Waddell and Reed sell substantial amounts of Putnam fund shares, no arrangements were made to reward them. Since these firms underwrite and distribute other major funds and therefore compete with Putnam funds, Management contends that reciprocal business would not encourage further sales and that money would be more valuable elsewhere (2317-9). But, a competitor such as Oppenheimer, which supplies research to Management, will be rewarded through reciprocal business, the policy being to provide equal amounts for sales and research (2319-20).

In order to get dollars to Planned Investment Corporation, the Canadian firm which underwrites and sells Putnam Growth Fund shares, an arrangement was devised at the suggestion of that corporation. Management directs its lead brokers to give up New York Stock Exchange commissions to NYSE members identified by Planned Investment. These members are told that the give-up was requested by Maxwell Ohlman, but it is unclear exactly what role Ohlman played. It was not known whether Ohlman or the member receiving the give-up pays the Canadian firm, but about $40,000 was in fact paid to the firm based on a believed one to one ratio with the give-ups (2321-6).

Generally, Management does not direct the manager of underwritings purchased by one of its funds to name designated NASD dealers as selling group members or co-underwriters. Member and non-member firms are, however, named to receive dealer discounts as a way of giving them reciprocal business. Management has never directed dollars back to the funds by naming its own underwriters, which are NASD members (2329-30).

The practice of Management with regard to a tender offer for a security held in the portfolio of one of the Putnam funds has been to designate dealers who sell Putnam fund shares to handle the transaction and receive the tender solicitation fee. Though there has been no attempt to check with the NYSE regarding rules prohibiting return of these fees to the customer, the policy of Management is not to designate its own NASD underwriters. Under circumstances where the stock was not in a Putnam fund portfolio, no underwriter or dealer has been named (2330-1).

No calculation has been made showing the number of dollars which would have been returned to fund shareholders had the various schemes used to transfer dollars to brokers, etc., been used to return money to the funds (2333).

BLOCK TRANSACTIONS

The desire to buy and sell stock in large blocks whenever possible makes it necessary for Management to use secondaries or exchange distributions as well as major lead brokers. Though these secondaries account for about 5% of total liquidations, their use has declined in recent years because of the emergence of a group of large brokers who position and buy large blocks of stock for their own accounts. Management and the trading department act on behalf of the funds and negotiate the best price. Brokers are not asked to give up any part of their commission from these trades (2239).

Where there is a large block transaction, the broker may position part of it and cross the other part. In such a case, Putnam asks that there be a give-up only from the part crossed and not on the portion taken for the firm's own account. It is felt that the funds' shareholders will net a better price on the transaction since there is a risk involved in positioning and the retention of the entire commission for this part of the trade provides a cushion to absorb some of that risk. The contention is that if the give-up was extended to that portion which is positioned, the broker would decrease the amount positioned instead of simply raising the price he charges. But, when it was suggested that the broker might be willing to give up more on the positioned portion if he did not have to give up anything on the part he crossed, the witness contended that there was no risk in the crosses and that the broker actually separated in his mind the two types of transactions and the commissions involved (2247-9).

CONCLUSION

By way of comment, the witness expressed three points: First, a volume discount on each national exchange would help the funds; second, from an internal operating point of view, a minimum rather than a negotiated rate would be preferred; third, participation by non-member firms in NYSE and other exchange commissions would be helpful. In clarifying the last point, the witness was asked whether he was suggesting that non-members have access to the NYSE for their own trades or that non-members have access so that they can receive give-ups on NYSE executions. Though at first the answer suggested the former, it became evident that by "participation by non-member firms" the witness meant participation in give-ups. Such access would allow Management to expand its distribution of give-ups to non-members directly by giving them orders for execution with NYSE member firms (2335-2336).

With regard to negotiated rates, the witness could not speculate on how Putnam would operate if such rates became effective. But it was admitted that negotiation is in fact presently involved in determining the amount of give-up since exchange rules do not allow 100% of the commission received to be given up (2250).

EXHIBITS

Among the exhibits presented was a table showing a break-down of net asset value, purchase share asset value, and other dollar aggregate figures such as capital gains distributions, sales redemptions, etc., for each of the Putnam funds (Exhibit 250). A summary of total dollar portfolio trades on the NYSE, Annex, and regional exchanges in 1967 and 1968 (Exhibit 251) and a table showing the cash flow from contractual plans (Exhibit 252) were also admitted. Exhibits 254 and 255 listed those firms which received dollars -- Hertz, Neumark and Pressman, Frolich and First Hanover, respectively.

WADDELL & REED
July 30, 1968 -- pp. 2341-2428

Introduction

Waddell & Reed was called to explain the variety of techniques which it uses, including methods dependent on institutional membership, for returning excess commission dollars to the mutual fund shareholder.

Waddell & Reed (W&R) is the investment adviser and principal underwriter for United Funds, a group of four funds with combined assets totalling $2,6 billion (2342-2343). The funds are distributed primarily by W&R's own sales force of 3900 registered representatives; at the present time less than 1/2 of 1% of total sales are made by other broker-dealers (2343-2344). Mr. Joe Jack Merriman, the major witness, described briefly the responsibilities of the investment manager and the method of computing the management fee (2344-2346).

Kansas City Securities Corp.

Kansas City Securities Corp. (KCS), is a broker-dealer subsidiary of W&R and is a member of the PCSE and the NASD. It has about ten employees, two of whom are brokers on the floor of the PCSE. (2346-2347, 2353). KCS has a few "individual" customers; it mainly services institutions and other broker-dealer. Its principal customer is United Funds (2347). W&R established KCS as a subsidiary in 1965 in order to seek PCSE membership, by which means it could better service its fund customers, reduce the brokerage costs of the funds it managed, and also make a profit for W&R. KCS was admitted to membership in 1965 (2348).

Mr. Merriman and Mr. Valicenti, the firm's General Counsel, explained the events which led up to KCS's membership on the PCSE. W&R had explored the possibility of membership on the NYSE but found it was not eligible. It then turned to the MSB, DSE, and PCSE. It was not eligible under MSB rules but was under the rules of the other two exchanges. W&R decided to concentrate on the PCSE. The staff introduced as Commission Exhibit 257 a copy of a statement submitted by W&R to the PCSE early in 1965 in support of its application which outlined the reasons why it believed it was qualified for membership. It contained a reference to possible antitrust action if that application was denied (2353-2356). Later during the testimony there was a discussion of the problems which W&R would have faced in trying to join the PCSE if KCS had been a subsidiary of United Funds rather than of W&R. Mr. Waddell felt that the membership probably would have been denied (2426-2427).

The witness explained the terms of the management contract relating to the profits of KCS. The management fee charged United Funds by W&R is reduced monthly by the greater of: (1) 100% of KCS's net profit attributable to direct executions for United Funds, or (2) 50% of KCS's net income after taxes from all sources (W&R retains the other 50%). The second provision has always been the applicable one (2348). The record contains figures which show the reduction that has been made in the management fee in each year (2348-2349). Currently, this results in a 15% to 20% reduction in the management fee and a return to the fund of an amount equal to approximately 10% of total brokerage costs paid by the funds. Both percentage figures have been rising for the past 3 years (2349-2350).

Exhibit 258 is a document prepared by W&R which shows its major sources of income (2356-2359). Subject to best execution, W&R directs business to wherever it will be possible for KCS to receive commissions, directly or indirectly. Of KCS's total income of $6.3 million in 1967, $1.3 million (21%) is classified as commissions received from United Funds. While the record is not entirely clear, it appears that this figure includes crosses taken by other brokers to the PCSE where they retain floor brokerage of 10% and give-up 90% to KCS, as well as trades where W&R is actually using KCS as a lead broker, in which case KCS receives 100% of the commission (2368-2371). It is unclear from the record whether other crosses taken to the PCSE, where KCS receives 70% of the commission at the direction of W&R on United Funds side of the trade (2367-2368), are included as commissions received from United Funds or under a second category, "give-ups received at the direction of W&R." This latter category, which includes give-ups on other regional exchanges, accounts for from 5 to 10% of KCS's gross commission income.

W&R directs that crosses be taken to the PCSE whenever possible (2371, 2378). As a rough guess, Mr. Baker thought that perhaps 25% of United Fund's transactions were crosses (2371), but state that many of the crosses are not done on the PCSE (2372). Figures were given listing total commissions paid by United Funds on the various exchanges (2372-2373).

The witness was asked why the proportion of KCS's commissions received from reciprocals was increasing (from 48% of total income in 1966 to 69% in 1968) (2375) while income from direct executions and from give-ups was falling (2374). Transactions executed on the PCSE at a give-up of 70% or 90% should return more to fund shareholders than does the present maximum reciprocal of 67% (2375-2376). The witness answered that he thought that direct executions were declining because of the type of stock recently being traded; it might not have active west coast markets (2374). He added that crosses are becoming more difficult to find (2374). and furthermore, that more reciprocals are being returned to the fund because the reciprocal ratios are improving. Reciprocals used to be on a 2:1 basis, but now some firms do it for 1 1/2:1. This gives KCS a higher return from the same commission dollars (2375-2376).

Three smaller categories of revenues were touched upon briefly (2380-2384). Each category apparently included a variety of items,. The first group encompassed commissions on orders received by KCS from institutions and from other brokers (2380-2381); the second consisted of floor brokerage earned from other members (2381-2382). Both apparently include reciprocal transactions as well as ordinary business. The third category, "miscellaneous", appears primarily to be a type of reciprocal arrangement involving give-ups on unrelated trades on regional exchanges (2383-2384).

Give-Ups and Reciprocals -- Policy

Exhibit 259 is a table showing the allocation of United Funds portfolio brokerage for various purposes (2387). Total commissions of $16.5 million paid in 1967 are divided into classes that are described in detail in the record. Both direct commissions and give-ups are used to reimburse for research services. In 1967, $161,000 was allocated for direct executions, on which no give-up was required (2387-2388); $965,000 in give-ups was directed to other brokers for research (2391).

No give-up was required in certain other instances. None was required for transactions involving position bids, which in 1967 accounted for commissions of $1.2 million (2388-2389). There is also a miscellaneous category involving $300,000 in commissions where no give-up was required for a variety of reasons, for example, when a purchase was being made on the recommendation of the broker involved (2389-2390). The witness indicated that W&R does not give a firm which has taken a loss on a block positioning trade a break on a later transaction by giving it an easy block to execute or by allowing it to retain full commission on a trade (2409).

About $3.8 million of the fund's 1967 commissions were paid on a give-up basis with the give-up varying from 40% to 70% (2390). Give-ups actually paid totaled $1.4 million (2392). There is no standard arrangement? the give-up varies from trade to trade, from exchange to exchange, and from broker-to broker (2396). The 40% is primarily on regionals and the 70% on the PCSE. The most usual ratio on NYSE trades is 60% (2393). The record shows typical give-ups arrangements for a few of the larger brokers (2395). Some give-ups went for research and the remainder went to KCS (2391). W&R does not direct give-ups for sales of fund shares (2384). The witness indicated that there was a large backlog of give-ups available for distribution at the end of 1967 for which W&R had not then directed payment, primarily because the money was not needed at that time. The backlog represented give-ups on NYSE transactions where KCS was not an eligible recipient (2390-2395). In 1967, $9,2 million was directed to broker-dealers who would reciprocate to KCS. W&R does not use give-ups as a basis for reciprocals; all reciprocals are based on direct executions for United Funds (2404, 2409). Various methods are used to reciprocate. Give-up checks may be paid on unrelated trades on regional exchanges, firms may direct floor brokerage to KCS or may give KCS crosses to execute on the PCSE, at full or less than full commission (2399-2400). However, most reciprocals are returned through the four-way ticket.

KCS has arrangements for reciprocals via the four-way ticket with about 40 brokers (2402). Ratios vary between 1 1/2:1 and 2:1, the ratio generally being computed on a net basis ($1 returned net to KCS after paying costs of floor brokerage and clearing) but is a gross figure under some arrangements (2401-2402)0 More than half of the brokers are on a 2:1 ratio and about 25% are on a 1 1/2:1 ratio. Naturally, the firms offering the better rate tend to get more business, so the majority of KCS's reciprocal business is on a 1 1/2:1 basis (2402-2403).

There was a brief discussion concerning the operation of the four-way ticket (2359-2361). Mr. Merriman disagreed that the four-way ticket was, in economic effect, equivalent to a give-up. He said that it was merely a system established by the PCSE to handle reciprocal business. He indicated that KCS is more than just nominally in the picture. For example, the firm is responsible in case of a fail (2361). Various items of expense and the amounts involved were listed for KCS's 1967 operations (2362-2364). KCS has $6 million of capital invested. The witness indicated that this capital is used primarily to pay for securities and to clear trades (2362, 2364-2366). The Commission staff suggested that the $2.87 million in profit earned by KCS in 1967 could be considered a return on this capital investment (2364, 2366).

A list of United Fund's largest executing brokers was read into the record (2384-2385) and a summary of the gross commissions received, the reciprocal arrangements, and the give-ups paid were submitted as Commission Exhibits 260 and 260-AC The record contains a discussion of the figures in these exhibits (2404-2415). Certain apparent discrepancies between "commissions received" and "give-ups and reciprocals paid" were explained as caused by time lags. (2407-2408, 2411). The Commission staff suggested that many of the brokers suffering these lags were major NYSE institutional brokers who had few small trades and who would probably have to bring more crosses and blocks to the regionals if they were to meet their reciprocal obligations. The witness agreed and indicated that if the brokers did not meet these obligations they would probably begin to lose business (2411). There was a brief discussion concerning the tendency to select brokers who could reciprocate easily and efficiently. Mr. Merriman agreed this might be true, subject to best execution, but then stated he felt this was not true (2410).

Two of the company's major lead brokers, Jablonski and Donaldson Lufkin are not PCSE members. Donaldson reciprocates by giving KCS crosses to execute on the PCSE at the full non-member rate. These crosses are generally done after the close in New York (2412-2413). The arrangement with Jablonski was not discussed in detail. W&R agreed to examine the record of Jablonski's testimony and to submit comments and corrections at a later time (2413-2315).

In 1967 Jablonski tendered a block of shares for United Funds and received the tender solicitation fee in return for reciprocals paid to KCS. There has been no other transaction in 1967 or 1968 involving direction of a tender solicitation fee to another broker (2415-2418). W&R has never requested that KCS or another broker be named as member of a selling group on an underwriting in order that W&R could receive a portion of the underwriting compensation (2416).

<u>Policy</u>

Mr. Waddell was asked to distinguish between a negotiated rate and W&R's present practice with regard to commissions, reciprocals, and give-ups (2418-2423). He agreed that negotiation plays a principal role under both systems but said that negotiation was more indirect at present (2418,2423). Under a negotiated system the rate could also be varied according to the service provided. While W&R tries to drive a hard bargain, he feels that under free negotiation the broker-dealer might retain less and the fund therefore would save more. However, he does not think a negotiated rate is feasible because of the uncertainty involved in determining when the lowest possible commission had been obtained (2419-2421). This was followed by a brief discussion concerning United Funds' transactions in the OTC market (2421-2423).

There was also a discussion of the policy considerations involved in the retention by W&R of 1/2 of the profits of KCS. Mr. Waddell feels that W&R is getting the benefits of lower brokerage for its funds and that W&R is entitled to profit too. He pointed out that other fund managers get benefits from portfolio brokerage through reciprocals for fund sales, and that some fund managers are members of the NYSE and get an even more direct benefit (2423-2425).

Mr. Valicenti stated that W&R would like to submit a position paper on the general subjects covered by the hearings, including such matters as volume discounts, reciprocals, give-ups and institutional membership (2428).

Exhibits

Exhibit 257 is a copy of a statement submitted by KCS to the PCSE in support of its application for membership in early 1965, Exhibit 258 summarizes the principal sources of KCS's income for 1966, 1967 and the first quarter of 1968, while Exhibit 259 shows the functional distribution of United Funds' 1967 commission income. Exhibit 260 is a table listing for United Funds' fourteen largest portfolio brokers statistics relating to the gross commissions received, give-ups paid, commission dollars allocated to reciprocals and reciprocals actually received by KCS. Exhibit 260-A makes certain corrections in the figures appearing in Exhibit 2600 Exhibit 261 was reserved for a letter from Waddell &

Reed, commenting on Jablonski's testimony with respect to his arrangements with W&R and KCS.

AMERICAN EXPRESS COMPANY
July 30, 1968 -- pp. 2429-2462

Introduction

Howard L. Clark, President and Chief Executive Officer of American Express Company, testified.

American Express is a publicly-held corporation with about 19,000 shareholders. Its shares are traded over-the-counter. One of its subsidiaries is Equitable Securities, Morton Company, a registered broker-dealer with membership on the Midwest Stock Exchange. American Express is in the process of acquiring a mutual fund subsidiary. Fund America. The testimony concerned these two subsidiaries, centering on ramifications of institutional membership and the prospects of rebative arrangements between these two subsidiaries.

The activities of American Express and its many subsidiaries consist primarily of travel and financial services, including travelers checks, money orders, credit cards, commercial banking, municipal bond underwriting and distribution, and overseas investment account brokerage and management activities (2430). Assets of the consolidated group of American Express subsidiaries totaled approximately $1.7 billion at the end of 1967 (2431). A subsidiary, Rexport, handles the equity investments of the consolidated group; as of July 10, 1968 the market value of these investments equaled $46.8 million (2431-2432). The American Express International Banking Corporation owns an additional $2 million in equity securities.

American Express does business with about 25 brokers. Mr. Clark testified that it does not direct give-ups on its own portfolio transactions; instead it places its commission business with firms which provide it with research (2449). American Express presently pays approximately $50,000 a year in commissions (2455).

Broker-Dealer Subsidiary

In May 1966, American Express acquired W. H. Morton and Company, a firm specializing in the underwriting and distribution of municipal bonds. Mr. Clark stated that the reasons for this acquisition were diversification and utilization of

Morton's management talents for American Express' large municipal bond portfolio which is valued in excess of $300 million (2432-2433).

Equitable Securities Corporation, a broker-dealer firm doing a general securities business was acquired by American Express in March 1968 (2433). At the time of acquisition, Equitable Securities had a capitalization of $100 million (2434). Its 1967 revenue break-down was given as follows: municipal bond underwriting, $1 million; corporate stock underwriting, $1,300,000; corporate bond underwriting, $1,300,000; over-the-counter commission business, $360,000; municipal bond trading, $45,000; corporate bond trading, $114,000; mutual fund sales, $60,000; and commission business on the Midwest Stock Exchange, $720,000. The firm now has 44 salesmen, and makes markets in about fifty local Midwest securities (2435-2436).

Mr. Clark stated that Equitable was not acquired for the purpose of obtaining rebates of commissions (2458). It was acquired for diversification purposes, to supplement the W. H. Morton business, and through merger, to provide American Express with some capital (2436-2437). Subsequent to acquisition, Equitable Securities and W. H. Morton were merged to form Equitable Securities, Morton Company, with a capitalization of $11 million (2434).

Equitable Securities had been a member of the Midwest Stock Exchange since 1948, and, subsequent to the merger, that seat was transferred to Equitable Securities Morton (2438). The firm kept its Midwest Stock Exchange membership solely for the purpose of continuing established Midwest Stock Exchange business; American Express made no attempt to have Equitable Securities Morton join an exchange in order to secure rebates for American Express (2458).

According to Rule 7, Article XV of the Midwest Stock Exchange, no subsidiary of a bank or trust company may be registered as a member corporation (technically, American Express is not a bank). In negotiating the transfer of membership, the Midwest Stock Exchange stated that this rule was intended to avoid potential conflicts of interest and to insure that membership does not become a vehicle for certain classes of customers to receive direct or indirect rebates of commission. Mr. Clark testified that the Midwest Stock Exchange at no time indicated to American Express that the rule related to any concern Midwest Stock Exchange might have over the need to regulate the ethics or conduct of the officers of American Express (2442-2443). Because the new firm was a subsidiary of American Express Company, however, rather than an independent securities company, the Midwest Stock Exchange asked for certain representations or agreements on part of the American Express Company before the seat was transferred. Three conditions were imposed: (1) that a majority of the Board of Directors of Equitable Morton would be full-time active officers of Equitable Morton; (2) that Equitable Morton's transactions on the Midwest Stock Exchange would not be directly or indirectly related to the securities transactions of the American Express Company or any of the American Express Company's affiliated organizations; and (3) that Equitable Morton and American Express would agree to furnish the Midwest Stock Exchange with such information regarding securities transactions and related activities of American Express Company as might be required by the Exchange (2439-2440).

According to American Express' interpretation of these conditions, American Express may not execute its corporate portfolio transactions directly through Equitable Securities Morton, or allow Equitable Securities Morton to receive either direct give-ups from a Midwest Stock Exchange member or reciprocal business from a New York Stock Exchange member (2445). American Express, which does not generate a great amount of commission business, sends this business to firms who supply it with research. Mr. Clark stated that, even in the absence of an agreement with the Midwest Stock Exchange, American Express would not be inclined to give commission business to Equitable Securities Morton unless it had a large research department which could produce research of the quality now received from the Wall Street firms American Express now does business with (2453,2454, 2460).

Equitable Securities Morton does not have its own broker on the floor of the Midwest Stock Exchange; it uses Lazard Freres in accordance with a reciprocal arrangement by which for every dollar of NYSE commissions Equitable Securities Morton pays Lazard Freres, it receives a net of 37 cents in unrelated reciprocal business (2457-2458).

Mutual Fund Subsidiary

American Express presently plans to acquire Fund of America, a holding company with four principal areas of operation: (1) property and casualty insurance; (2) life insurance; (3) computer leasing; and (4) the Fund of America Investment Management Company, the management company for four mutual funds known as the Commonwealth Funds (2450-2451). The net assets of this group of funds total approximately $400 million (2451).

Mr. Clark Stated that he has not discussed with counsel whether organizations acquired in the future would be subject to the Midwest Stock Exchange conditions (2445). It was his opinion, however, that the agreement would carry over to Fund of America (2452-2453).

Exhibits

Exhibit 262 is a copy of the agreement between American Express and the Midwest Stock Exchange. Exhibits 263, 264 and 265 are copies of an exchange of letters between the Midwest Stock Exchange and Equitable Securities Corporation concerning its application to transfer its seat to Equitable Securities Morton.

INVESTORS DIVERSIFIED SERVICES
July 31, 1968 -- pp. 2466-2539

Introduction

Investors Diversified Services (IDS) was asked to testify primarily because of its institutional membership on the PCSE and its arrangements for returning commission dollars, through give-ups, back to the shareholders of the funds which it manages. The primary witness was Mr. Robert Loeffler, a director and vice-president of IDS.

IDS and its subsidiaries are engaged in a wide variety of financial operations, including insurance, real estate, mortgages and lending activities and leasing, in addition to the primary business of the parent company, which is acting as investment adviser and sponsor for the largest mutual fund complex in the country (2467-2468). IDS is publicly owned, with about 46% of the voting stock held by Allegheny Corp. (2469). This stock is listed on the NYSE and the PCSE (2495).

The size and investment objectives of each of the four mutual funds in the IDS complex were described (2468-2469). These funds are distributed exclusively through IDS's own sales force of 3700 people, who sell only IDS products. IDS is registered as a broker-dealer and is a SECO member. The terms of the management contract were outlined briefly and the payments to IDS over the past 21/2 years under this contract were summarized (2470-2473, 2515). There was also a brief introduction to other aspects of the company's investment advisory operation, including the research and trading departments, as well as to IDS Securities Corp., discussed further below (2478-2477).

Portfolio Executions

Mr. Loeffler indicated that in choosing brokers for execution of portfolio orders, the sole criteria is best execution, and he explained some of the factors involved in determining what is best execution under a given set of circumstances (2477-2478). There was considerable discussion concerning the trading techniques used by a company like IDS whose portfolio decisions often involve large blocks of stock (2478-2486). The witnesses stated that this varied according to the nature of the transaction. Accumulations and sales may be gradual or in blocks (2478-2480). Extensive use is still made of the auction market. However, block trading has been increasing substantially. IDS's lead brokers are chosen primarily because of their expertise in the floor and in finding crosses (2482-2484). While several of the brokers (Exhibits 266-268) are block positioning firms, this is apparently not a major factor in selecting lead brokers (2480-2484).

A breakdown of IDS's portfolio business by market was submitted as Exhibit 269. This exhibit included figures for the Third Market and there was some discussion concerning commission charges in that market (2487-2488). Mr. Rotberg commented on the low percentage of executions done on the PCSE in 1968 and Mr. Loeffler said this was probably an aberration, based on figures representing only a 3 month period. He stated that as far as he could remember, executions on the PCSE had increased after IDSS (an IDS subsidiary) became a member, but that there had been no marked change (2489-2490). The firm's trader pointed out that IDS may prefer in some cases to use the PCSE where it can more easily conceal its hand (2505).

Give-ups

IDS's give-up policy is as follows: The general give-up on block transactions is 50% (2499-2502). On block transactions there is no give-up where IDS is selling, but usually give-up practices apply where the company is buying (2484). There is a group of brokers, the brokers IDS uses on its four-way ticket operations, who have voluntarily agreed to give up 70% on trades executed on the PCSE (2500-2501, 2503). IDS does not request 90% give-ups on the PCSE, although this would probably be possible under Exchange rules (2498). Neither does it generally request a broker to take crosses to the PCSE (2504), or to any other exchange.

These policies with respect to crosses, including a lower give-up ratio than with ordinary trades, reflect the company's interest in seeing that it gets exposed to as many blocks as possible, and that it does nothing to discourage brokers from showing blocks to IDS. IDS feels that a slight commission saving in this situation is not worth the possible costs involved (2504). It also feels that finding crosses may be more complex than working out an order on the floor and may be more beneficial to IDS (2503).

IDS has seven brokers on which it relies for research. These seven brokers give up 50% directly to Jefferies and Co. on both blocks and ordinary executions (unless they are positioning). All other NYSE brokers with which IDS deals give up 70% on ordinary trades and 50% on blocks; these give-ups are directed to Leif, Werle & Alston (2505-2507).

IDS Securities Corp.

IDSS, a wholly owned subsidiary of IDS formed In 1965, was admitted to membership on the PCSE on September 1, 1965 (2475). IDSS has no broker on the floor of the Exchange and its only office is in Minneapolis (2475-2495).

The subsidiary does not do a general brokerage business, but handles only transactions on behalf of IDS (2475-2494). The parent had sought this membership solely to reduce the portfolio commission costs of the funds in its complex (2491).

Mr. Loeffler indicated that consideration had been given to attempting to join the NYSE but that it had been obvious that IDS would not be able to do this "without blasting our way in." (2491-2492). There was a brief discussion of the preliminary negotiations between IDS and the PCSE, prior to being admitted to membership (2492-2493). The company is presently exploring, from an economic standpoint, the question of associate membership on the Amex (2493-2494).

IDS returns 100% of the net profits realized by IDSS to fund shareholders (2491). This is accomplished by a reduction equal to the IDSS net profits in the management fee charged by IDS (2496). Figures regarding the gross management fee and the amount of reduction were placed into the record (2472-2473, 2512-2515, Exhibits 270 and 271). Of total commissions of $15 million paid by the various funds in 1967, $4.1 million was returned to the shareholders (2529-2530).

IDSS receives its income principally from two sources. As a member of the PCSE, it is eligible to receive give-ups by check of up to 70% on IDS's own trades which are executed on the PCSE (2496-2497). The exact amount of give-up requested varies between 50 and 70%, according to the give-up arrangements described earlier. The other major source of income is through reciprocal arrangements involving the four-way ticket. The primary purpose of the give-ups channeled to Lief, Werle & Alston and to Jefferies, as described earlier, is to serve as a basis for reciprocals.

The technical aspects of the operation of the four-way ticket were touched on only briefly (2509, 2523-24). A copy of a daily four-way trade report sent to IDSS by the PCSE clearing corporation was included as Exhibit 276 (2528-2529) and a copy of a confirmation received from Jefferies relating to a four-way ticket transaction was put into the record as Exhibit 275 (2523-2524). The witness agreed that IDSS's name appeared on the confirmation merely to permit IDSS to get dollars back from Jefferies, and that IDSS actually performed no function in this transaction (2523-2524). He stated that while technically this is not a give-up, that is what it amounts to (2528).

The role of Lief Werle as a banker for IDS's give-up commissions, the various services this firm provides, and the method by which it is paid for these services was described (2508-2512, 2522-2523, Exhibit 274). Lief, Wede places the give-ups received from other NYSE members into an escrow account against which it writes give-up checks at IDS's direction to other NYSE members. Some of these checks go to pay for research (2508). Most, however, are paid to "reciprocal brokers" who have agreed to return 66 2/3¢ to IDSS through the four-way ticket for every $1 received from IDS under this arrangement (2509). This ratio was established by negotiation and is dependent on the forces of supply and demand (2518-2519). Mr. Loeffler explained that in computing the reciprocal ratio, the costs of floor brokerage and clearance, though actually paid by IDSS, are charged back to the reciprocal broker. He gave an example of what was meant by this, using $1 in commissions received by IDS as a basis (2516-2518). Exhibit 277 was introduced showing the calculations involved for a particular broker over a period of several months (2529).

Jefferies' role as a conduit of give-ups was also described (2524-2527). Assuming Jefferies received commissions of $1 million, Mr. Loeffler explained that Jefferies would in turn pay IDSS commissions of $1 million on the four-way ticket. IDSS would, however, absorb the floor brokerage and clearing costs involved in those trades, rather than charging them back to Jefferies. Jefferies profits under the arrangement would be the amount of these charges, which otherwise Jefferies himself would have had to absorb. IDSS nets a higher amount under this plan than it does under its other reciprocal arrangements.

Statements relating to IDSS's income and expenses were submitted as Commission Exhibit 272, 273-A, 273-B (2519-2521). Mr. Loeffler estimated that on a monthly basis IDS grosses roughly $600,000 and nets about $400,000 (2521). As explained earlier the 2 largest expense items shown in the income statement, floor brokerage and clearance, are as a practical matter not really expenses of the fund (2521) and often operating costs are relatively small (2515-2516).

<u>Negotiated Rates</u>

The witness stated that he did not feel that there was any difference between IDS's current arrangement and a negotiated rate. At present, he feels that IDS is getting the best possible service from what it considers to be the finest brokers on the NYSE for 30% of the non-member commission. The figure was arrived at through negotiation, In situations where extra service is provided, the broker keeps 50%. IDS does not ask for a 90% give-up, because it feels it would not get the desired level of service at that rate. It is a matter of judgment (2532-2534).

IDS would prefer a true negotiated rate. The witness felt that this would not result in haggling over commissions on individual transactions, but that it would result in the same type of arrangement as exists today and as described above (2536-2537). IDS feels the present system is awkward and inefficient (2536). Under present methods of returning commissions to IDSS there is considerable leakage through transportation costs.

The witness did not have a dollar figure as to the amounts currently being lost to conduits (2532). However, he indicated that on a 701 give-up returned through the four-way ticket, the leakage will be 26 2/3% (1/3 of 70%) and on a 50% give-up it would be 16 2/3% (1/3 of 50%). (2530-2532) This is a cost which is incurred because of the peculiar commission rate structure, and it could be saved if the dollars could be returned more directly (2531-2532, 2537).

IDS does use give-ups to compensate for research at the present time but feels that it could adjust to this under a negotiated system. The management fee currently contemplates using brokerage to pay for research but the management fee could be increased and research paid for directly. Under the present commission rate system, however, it is cheaper to use brokerage dollars than real dollars to pay for research services (2534-2536).

Mr. Loeffler stated that IDS would like the opportunity, if IDS felt it appropriate after reviewing later data produced during the hearings, to submit a formal statement of its position. Mr. Rotberg assured the firm there would be plenty of opportunity to do that (2538-2539).