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November 13, 1984

The Honorable John S.R. Shad, Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear John:

Thank you for your gracious letter and the accompanying draft of your remarks before the Harvard Business School Club. I found the remarks most interesting, particularly as they relate to the record of accomplishment of the SEC under your capable administration.

Many of the initiatives undertaken by the Commission over the past three and a half years, such as the Insider Trading Sanctions Act, can only result, in my view, in the more efficient operation and application of the federal securities laws. Others, such as the Integrated Disclosure program, Rule 415, proxy simplification, and the broad overhaul of certain trading rules, particularly Rule 10b-6, have created an environment in which the substantive goals underlying the federal securities laws may be realized in a manner designed to permit compliance in the most efficient, least expensive manner. Moreover, the strong commitment to regulation by function represented by your proposal of, and participation in, Vice President Bush's Task Group On The Regulation Of Financial Services, is a commitment I strongly share. As I indicated at the Major Issues Conference earlier this year, regulation by function is the only rational approach to the dramatic changes that have occured in the financial services industry in the recent past and which, as a result of market forces, will continue to take place into the foreseeable future. If regulation is to keep up with these changes as they occur, without resulting in intentional or inadvertent competitive disparities, activities - not entities - should be regulated according to their function, rather than by the historic regulator.

In your comments relating to your future goals and objectives, you noted that the Commission's efforts to enhance investor protection in the most efficient manner possible are ongoing and will continue. For this I commend you. The EDGAR system, now in its pilot phase, promises enormous efficiencies for those who file documents with the Commission, for those who review them on the staff and for those who make use of the information set forth in those documents. Ultimately, our capital markets and the investing public will be significantly benefitted by this initiative.

One point of disagreement with your remarks as to future goals and objectives relates to Rule 14b-1(c). As we have contended through the proposal, adoption, and deferral of the effective date of Rule 14b-1(c), we see no need for a rule requiring broker-dealers to provide to issuers the names of the beneficial owners for whom they hold securities, subject only to a negative consent provision the effectiveness and appropriateness of which the Commission itself has strongly questioned when it has been proposed by industry representatives in other contexts. The deliberations and the Report of the Commission's Advisory Committee on Shareholder Communications offered no evidence that this industry's current method of providing proxy and other information to investors has in fact caused any serious difficulties. We thus believe that the rule is arbitrary and may be disruptive of the confidential relationship between a broker and its customers. In addition, as of now, the rule would, if implemented, impose serious competitive disadvantages on the securities industry vis a vis commercial banks, a point which is an interesting example of why you and I have advocated functional regulation.

While, as we have noted in the past, we have reservations about certain provisions of the tender offer legislation that the Commission proposed in the 98th Congress, I believe that this legislative initiative does reflect innovative thinking about the nature of the tender offer process, the array of defensive techniques available to a target company, and the reestablishment of the balance between bidder and target that the Williams Act, when enacted in 1968, sought to strike. In this regard, I am enclosing a copy of a letter submitted by Lloyd Derrickson, Vice President - Government Relations, Merrill Lynch & Co., Inc. to Representative Timothy Wirth, Chairman of the House Subcommittee on Telecommunications, Consumer Protection and Finance of the Committee on Energy & Commerce, commenting on the proposed Tender Offer Reform legislation.

On another legislative matter, we continue to be concerned over the indiscriminate use of the Racketeering Influenced and Corruption Organization Act ("RICO") by private litigants who seek to elevate garden variety customer complaints into treble damage claims and to label brokers and other industry professionals as "racketeers." I am troubled that the pattern of case law in the past several years has generally supported this expansive view, although several recent federal appeals court decisions have signaled a more reasoned view. I continue to believe that a legislative clarification of RICO is necessary and am encouraged by Commissioner Marinaccio's recent remarks in support of such an approach. For your information, I am enclosing a copy of a letter on this subject submitted by Stephen L. Hammerman, our General Counsel, to Vice President Bush's Task Group.

In your letter, you also asked for our comments and suggestions concerning goals that we think the Commission should pursue. I have asked a number of persons at Merrill Lynch to consider that request and am taking the liberty of attaching as an Appendix a memorandum setting forth certain specific recommendations, as well as an analysis of their rationale, which you may wish to consider in developing your regulatory agenda.

Thank you for providing me with the opportunity to address your thoughts and to present you with some of mine. The significant progress made by the Commission in the past three and a half years in moving away from the traditional approach to securities regulation toward a more efficient one has been remarkable. I have no doubt that the momentum which has developed will continue and that in the not very distant future the goals and objectives which you cited to the Harvard Business School Club will have become a part of your fine record. I hope, too, that you will find some of our suggestions useful.

Best personal regards.

Sincerely,

Roger

Roger E. Birk

Appendix

Persons in various positions and departments within Merrill Lynch, Pierce, Fenner & Smith Incorporated and its affiliates have been asked to consider the ways in which the federal securities laws, and the regulations thereunder, affect these entities. They have also been asked to consider regulatory adjustments that would enhance the efficiency of the regulatory system and our compliance with it, consistent with the underlying purposes of regulations. The following recommendations resulted from those inquiries, and are being offered to the Securities and Exchange Commission for its consideration.

1. Changes in Net Capital Requirements

Merrill Lynch supported the Commission's adoption in the recent past of several constructive amendments to the net capital rule. Certainly, they enhance the industry's ability to meet the competitive challenges presented by the banking industry's expanding securities-related activities. If the industry is to meet these challenges effectively, however, further regulatory reforms will be necessary.

During the last decade, the industry has demonstrated its commitment to protecting customer funds and securities through its compliance with possession and control requirements for customers' fully paid and excess margin securities and with the Cash Reserve Formula of Rule 15c3-3 under the Exchange Act, the customer protection rule. Additional improvements in the industry's ability to safeguard customer assets include the following:

- Improved data processing technology, development of net settlement clearing facilities, securities depositories and other operational enhancements.

- Enhanced controls regarding maintenance of security positions through compliance with Rule 17a-13 requirements regarding the verification of securities.

- Improved auditing techniques and better coordination between regulatory auditors, independent certified public accountants, and internal audit staff of broker-dealers.

- Increased customer protection through SIPC as well as additional customer account insurance purchased by broker-dealers.

In our view, the net capital rule continues to be more restrictive than is necessary to protect the investing public. As modified in the aftermath of the securities industry's operational crisis of 1967 to 1970, the rule is liquidation-oriented rather than being based on a "going concern" business concept. This approach, of course, does not take into account the industry's present ability to protect customer funds and securities.

RECOMMENDATION

Our industry's record on customer protection and regulatory compliance evidences substantial progress since the crisis atmosphere of the late 1960's and early 1970's. In addition, securities firms today tend to be much larger and better capitalized. Accordingly, we believe that the Commission should review whether it would be appropriate to eliminate the net capital rule and instead to rely on the customer protection rule to provide the financial control necessary today for investor protection.

2. Unnecessary Examination Requirements

In our view, present examination policies impose certain unnecessary and inappropriate testing requirements on securities industry personnel. The current National Association of Securities Dealers (NASD) qualification requirements for investment bankers, research analysts and senior personnel in financial and operations areas are overly-broad, burdensome and disruptive to the affected individuals. They are also costly to member firms and result in no tangible benefit to the public.

Section 15(b)(7) of the Exchange Act, as amended in 1975, directs the SEC to develop uniform and comprehensive qualification examinations for persons engaged in the securities business. This directive resulted from a recognition by the Congress that the qualification examinations of the self-regulatory organizations were not standardized as to topic coverage or consistently administered. By design, then, the NASD general securities registered representative and general securities principal examinations cover a wide range of subjects. Their purpose is to determine the product knowledge and competence of an individual to deal directly with public customers or to discharge a member firm's supervisory responsibility over its sales force. As a result of their all-encompassing nature, however, they are inadequate for assessing the competence of an individual to engage in, or to supervise, highly specialized activities, such as investment banking or securities research.

Studies of the rash of broker-dealer failures in the late 1960's--leading to the passage of the Securities Investors Protection Act of 1970--focused on the inexperience of management personnel in the financial and operations areas of many of the bankrupt firms. To address this problem, the NASD created a new principal registration category and an examination that is limited to determining the qualification of employees to manage the financial and operations areas of member firms. Unfortunately, any individual in this registration category must take an examination that gives equal weight to both operations procedures and financial rules. The examination thus does not take into account the segregation of financial and operational functions made necessary by the complexity of today's business environment.

It is clear that this limited category should be further streamlined. In fact, on an equal regulation basis, its very continuance may be questioned. Individuals employed by banks, insurance companies, pension funds and other financial institutions who perform, to the extent permitted by law, identical finance and research-related functions are not subject to any registration requirements. Further, the NYSE has no comparable test, but requires only that a member firm designate on Form U-4 an individual as being its chief financial officer.

RECOMMENDATION

Consistent with Section 15(b)(7), Merrill Lynch urges the establishment of limited registration categories for registered representatives and registered principals in investment banking and securities research. Their qualification examinations should be narrowly designed to determine the product knowledge and supervisory ability of individuals engaged exclusively in these activities. Consistent with the self-regulatory organizations' historical practice in introducing new examinations, individuals actively engaged in these areas prior to the first administration of these examinations should be grandfathered. Finally, the current NASD limited financial and operations principal category should be divided into two categories: financial principal and operations principal, with separate qualifying examinations.

3. Duplicative Filing Requirements

In addition to the registrations required of broker-dealers and their personnel by the Commission, the exchanges and the NASD, registration requirements currently are imposed by 49 states as well as by other administrative agencies, such as the CFTC. Compliance is duplicative, entails considerable time and expense and contributes materially to the paperwork which must be generated by a registrant.

Moreover, the various state registration requirements seriously hamper an individual's ability to change employment and promptly thereafter to resume providing services to customers. Even where an individual is already registered with numerous exchanges, self-regulatory organizations and states through a previous securities industry employer, the lack of any provision on the part of many states for an immediate transfer of registration to a new employer firm works to the detriment of the firm, the individual agent and, ultimately, the customer.

Aside from imposing unwarranted economic hardship on the individual changing his employment, the above requirements expose firms and their personnel to state-initiated regulatory actions and to financial loss when customers avail themselves of the statutory right to rescind trades based even on technical, inadvertent or ministerial shortcomings or delays in the agent registration process. Customers are thus able to take advantage of a "windfall" opportunity to disavow losing transactions at the expense of the broker-dealer, notwithstanding the absence of any substantive misconduct.

As to duplicative registration requirements in the securities area, some progress has been made through the Consolidated Registration Depository (CRD). The CRD, developed jointly by the NASD and the North American Securities Administrators Association, Inc. (NASAA), facilitates personnel registration with the NASD, certain other self-regulatory organizations and the many states which participate in the system. More work, however, remains to be done in this area.

RECOMMENDATION

At the Commission's urging, provisions of the 1975 Securities Acts Amendments greatly enhanced the ability of SROs to divide oversight responsibilities efficiently among themselves, with a significant reduction in unnecessary filings and industry expense. In addition, there has been some consolidation of the federal, state and SRO securities registration process through the implementation of the CRD. It would seem timely to press for further consolidation of state and other registration and oversight functions as well as for a more equitable approach to purely technical non-compliance.

4. Unnecessary Regulation of Canadian Affiliates

Under a long-standing policy of the New York Stock Exchange, registered representatives associated with the Canadian affiliates of member firms have been required to take and pass the Series 7 examination as a condition of continued employment. This requirement is applied without reference to transactions with U.S. nationals in Canada or activity in U.S. securities. Whatever may have been the original rationale underlying this rule, the existence of appropriate regulatory bodies in Canada and the strict legal separation of Canadian affiliates has rendered this policy obsolete. It imposes a needless hardship on prospective registered representatives, who derive no gain whatsoever from the time expended. It places Canadian affiliates of NYSE members at a competitive disadvantage vis a vis other Canadians firms, since the considerable effort involved in preparing for and taking the examination can be a powerful disincentive to association. Moreover, this rule unnecessarily antagonizes Canadian regulatory authorities and provincial administrations already sensitive to U.S. intrusion into their nation, with no corresponding benefit to justify it.

RECOMMENDATION

In the absence of any continuing useful purpose for this policy the Commission should explore with the NYSE its prompt repeal.

5. Integration of State and Federal Regulations

The Commission has acted diligently to improve the cost efficiency and specificity of its regulations and continues to take initiatives to promote that goal. These efforts ultimately will facilitate the capital raising and marketing process, consistent with the Commission's statutory responsibilities.

As federal regulations become increasingly efficient, however, the counterproductive effects of the diverse state rules become more apparent and more troublesome. The current need, therefore, is for a reconciliation of state and federal regulations (beyond the simplification of filing and registration requirements noted earlier). The Commission and NASAA have worked together in this effort, creating, for example, streamlined and efficient standards for private offerings which could be adopted by all of the states. Unfortunately, this spirit of cooperation has not produced results in every state.

The extent to which time and resources are diverted to dealing with state regulatory bodies on issues that are duplicative or as to which there is an unnecessary lack of uniformity is of serious concern to responsible firms throughout the industry. Also, the penalties sought by state regulatory bodies are too frequently disproportionate to the nature of the underlying deficiency or violation.

RECOMMENDATION

We fully support the Commission in its efforts to promote uniformity and centralization, and a coordinated approach should be made to identify those states where discussions with regulators would be most appropriate.

6. Recognition of Internal Disciplinary Actions

Responsible broker-dealers and the regulatory authorities share a common goal of maintaining sound and well-understood standards of conduct. That shared objective has given rise to a spirit of cooperation in connection with compliance matters. In evaluating minor regulatory infractions, for example, disciplinary authorities have long taken into account the penalties imposed on erring personnel by their registered employers in determining the need for further disciplinary action.

RECOMMENDATION

The above spirit of self-regulation (true self-regulation, which originates with the broker-dealer rather than an SRO) should be further explored, with an eye to regularization of the function and formal recognition of a firm's internal disciplinary measures.

7. Section 11(a) of the Exchange Act

Section 11(a) restricts the use of stock exchange memberships in trading for managed institutional and certain proprietary accounts. Adopted with the support of the securities industry as part of the 1975 Securities Acts Amendments, it was intended to address potential conflicts of interest arising from institutional membership on the exchanges. The elimination of fixed brokerage commission rates in 1975, however, effectively ended institutional interest in stock exchange membership, and hence the need for this provision.

Section 11(a), however, remains in effect. Its current practical effect is to require that a firm direct orders for the covered accounts to brokers not associated with it. The Commission has responded to the unintended obstructions the law creates by promulgating exemptive rules permitting the types of business that otherwise would be prohibited, except as to the actual execution of trades.

RECOMMENDATION

In view of industry developments over the past nine years, and the resolution of the problem at which it was directed, Section 11(a) should be repealed.

8. Section 13(f) of the Exchange Act

Section 13(f) requires larger investment managers to make quarterly public reports of their securities holdings. It was passed in 1975 as an outgrowth of the Commission's Institutional Investor Study, to improve the data publicly available concerning institutional investments. These reports have been generated for almost 6 years, at considerable expense but without any demonstrable public benefit. In fact, the disclosure of firms' investment positions has had the undesirable result of hindering risk arbitrage and acquisition strategies.

The quarterly reports required under Section 13(f) disclose investment strategy and, in many cases, may effectively tip the hands of major arbitrageurs. Both investment and risk arbitrage strategies represent proprietary information that is used in a highly competitive environment. Their compelled disclosure deprives the originator of some of the benefits of his work.

RECOMMENDATION

Absent a showing of substantial public benefit and in view of its cost and potentially detrimental effect, Section 13(f) should be repealed.

9. Sections 13(d) and 16(a) of the Exchange Act

The application of Sections 13(d) and 16(a) to certain arbitrage activities results in unnecessary expense and can compromise firms' risk arbitrage strategies. Section 13(d) generally requires disclosure of all equity positions at or exceeding 5% of an issuer's voting stock. Under Section

13(g)(1), these disclosure obligations have been relaxed for broker-dealers purchasing in the ordinary course of their business (as market maker, investment manager, etc.), but full reporting continues to be required where there is an ongoing contest for control of the issuer.

Section 16(a) compels disclosure of purchases and sales by, among others, holders of 10% or more of "any class of any equity security." In 1967, a landmark case held that, in the case of convertible securities, the "class of...equity security" referred not to each separate sub-class but to the totality of shares into which the convertible securities could be converted. While the SEC has stated that this holding will be followed for Section 16(b) purposes (recapture of short-swing profits), full reporting under Section 16(a) of holdings of each sub-class has been required (most recently in Exchange Act Release No. 18114, September 23, 1981). While this expansive interpretation may be justifiable for true insiders, there seems to be no similar rationale for applying this reporting obligation to the investment holdings of broker-dealers.

RECOMMENDATION

We understand that the Commission is about to embark on a study of Section 16 and its application. Such a study is very timely, and the Commission should be commended for it. We believe that, where a broker-dealer holds equity securities, but does not directly participate in or influence the management of the issuer, its reporting obligations should be those specified in Section 13(g)(1) and the rules thereunder. Further, unless the SEC demonstrates some reasonable justification for applying Section 16(a) to convertible securities held by broker-dealers, the current interpretation should be amended consistent with the SEC's existing positions under Section 16(b). We hope that these matters will be considered in connection with the upcoming study.

10. Regulation of Money Market Fund Transactions

In recent years, major innovations in our financial markets have included the development by securities firms of in-house money market funds. While these investment vehicles are technically securities (that is, shares of registered investment companies), the overly strict application of securities regulations, developed long before the inception of money market funds and obviously not in contemplation of them, may unnecessarily restrict firms' activities in processing money market transactions.

Rigid applications of traditional securities regulations to transactions in money market fund shares have, for example, subjected firms to criticism and/or regulatory actions on the theory that these mechanical transactions should be entered or processed only by registered personnel. Similar challenges or criticisms have been based on the notion that purchases or liquidations of money market fund shares in conjunction with other market commitments and in keeping with ongoing understandings with customers (but absent a written agreement or specific, trade-by-trade instructions) constitute unauthorized trades. That position is an example of the inappropriate application of regulatory standards with sound original purposes.

The regulatory standards relating to unauthorized transactions were developed to preclude the abuses that result from the exercise of unauthorized discretion. Typical abuses have included generating excessive commissions and subjecting customer assets to unauthorized risk. These dangers are not present, however, in money market fund transactions, where no charge is made to the customer for purchases or liquidation and where the objective is to maintain customers' funds, in keeping with customers' expressed wishes, in an interest-earning medium between other investment commitments.

Many customers now use money market funds as an integral part of their investment activity. Some customers initiate investments in in-house money market funds for the specific purpose of keeping funds available (and earning interest) between investments in other securities. Others confine their investments to a money market fund and, once such an account is opened, seek only the service necessary to process the purchase or sale of shares as they deposit or withdraw funds. In either instance, significant numbers of transactions, and the attendant operational burdens, may result. Consequently, broker-dealers have devised various methods for the automation or semi-automation of the processing of money market fund transactions. Some brokers also have developed procedures for the liquidation of money market fund shares to satisfy the need for funds for customer purchases of other securities on settlement dates.

The mechanical processing or operational transmission of orders by non-registered operations or clerical personnel in these funds is a common and recognized practice in the industry. These personnel do not solicit customer transactions or participate in customers' investment decisions. Non-registered operations employees simply process transactions upon specific instructions from or under the supervision of registered persons, in keeping with a standard procedure.

RECOMMENDATION

While procedures such as those described are in place at some broker-dealers and under active consideration at others, they are subject to bothersome and time-consuming challenges based on technical interpretations or inappropriate applications of outdated regulatory concepts. There is a need for a thorough review of the regulation of money market funds to assure efficiency and to avoid unnecessarily restrictive regulation. It might be productive specifically to solicit industry comment on money market investment company regulation.

11. Money Market Fund Shareholder Voting Requirements

Numerous sections of the Investment Company Act of 1940 require approval of certain actions by vote of a majority of the outstanding voting securities of the investment company. Section 2(a)(42) defines such a vote to be the lesser of: (A) 67% or more of the voting securities present at a meeting where at least 50% of the outstanding securities are represented; or (B) more than 50% of the outstanding securities. It is often difficult to obtain a quorum at shareholder meetings of money market funds. This is due partly to the high turnover of money market fund shareholders, many of whom may be shareholders on the record date but sell their shares shortly thereafter. Even among those shareholders who retain shares for longer periods, voting response is generally lower than for equity or fixed-income funds.

RECOMMENDATION

To eliminate quorum problems for money market funds, Merrill Lynch recommends the adoption of a provision in Section 2(a)(42) that would allow for lower voting requirements in the case of money market funds. Shareholder approval might be considered valid, for example, if at least 25% of the outstanding shares of a money market fund are represented at a meeting, and of this 25% at least 80% vote in favor of a proposal.

12. Trading with Affiliates

Section 17(a) of the Investment Company Act of 1940 generally prohibits principal trades between affiliated persons. It is possible to get an order exempting transactions from this provision, but this is a lengthy process. More leeway should be given for money market funds to engage in principal transactions with affiliated persons either under particular conditions that could be set forth in a rule or on a broad fiduciary duties basis.

RECOMMENDATION

Given the rapid changes in the nature of money market investment companies, it might be appropriate for the Commission to explore relief in the area of trading with affiliates.

13. Burdensome Position Limit Requirements

According to the Special Study of the Options Market, the position limit rules of the exchanges were originally adopted primarily to 1) minimize manipulative potential, 2) prevent the accumulation of large option positions which might, upon exercise, affect the price of an underlying security, and 3) limit the financial exposure of market participants. In 1973, the position limit established to protect against these perceived evils was 500 contracts on one side of the market. With the introduction of puts in June of 1977, the position limits were increased to 1,000 contracts on either side of the market and in November of 1981, the position limits were increased to 2,000 contracts.

Last year, the Commission adopted a two-tier increase in position and exercise limits. This two-tier position limit rule increases existing limits to 2,500 option contracts or 4,000 option contracts on either side of the market, depending upon trading volume in the underlying security.

Mutual funds that have separate portfolio managers with distinct and different investment objectives and limitations, do not share in each other's profits and losses and are closely regulated to assure adherence to the fiduciary standards owed to their shareholders, should be subject to separate position limits. The fact that the funds are under the same management company should not result in the funds' being required to aggregate options positions to satisfy a single limit.

This recommendation is based on the following facts:

1. Although a "family" of funds may be managed by a single management company, these funds operate under different investment policies and objectives. It is rare to find more than one fund in a fund complex trading under similar options strategies.

2. The day-to-day investment decisions for funds are made by their managers in accordance with objectives outlined in their prospectuses. The managers may be employees of a single management company, but they must follow the investment policy of the individual fund.

3. Mutual funds and fund managers are highly regulated under the Investment Company Act of 1940 and the rules thereunder.

RECOMMENDATION

Merrill Lynch urges that permissible position limits reflect the actual differences between separate investment companies, and that the regulations be revised accordingly.